Petition

81-930

No.

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In the Supreme Court of the United States

OCTOBER TERM, 1981

UNITED STATES OF AMERICA, PETITIONER

v.

BLISS DAIRY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED

Whether a liquidating corporation was required to include in its gross income for the year of its liquidation an amount equal to the value of unconsumed cattle feed distributed to its shareholders, where the corporation had previously deducted the cost of that feed in full, and where the shareholders acquired a "stepped-up" basis enabling them to claim a further deduction for the feed when it was consumed during their subsequent operation of the business.

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No.

UNITED STATES OF AMERICA, PETITIONER

v.

BLISS DAIRY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the district court (App. A, *infra*, 1a) is not reported. The opinion of the court of appeals (App. B, *infra*, 2a-5a) is reported at 645 F.2d 19.

JURISDICTION

The judgment of the court of appeals was entered on May 11, 1981 (App. C, *infra*, 6a). The order denying the government's petition for rehearing (App. D, *infra*, 7a) was entered on July 31, 1981. By order dated October 21, 1981, Justice Rehnquist extended the time within which the government could file a petition for a writ of certiorari to and including November 21, 1981. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant provisions of Sections 332, 333, 334, 336 and 337 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in App. E, *infra*, 8a-10a.

STATEMENT

Respondent was engaged in the business of operating a dairy. It kept its books and filed its income tax returns using the cash method of accounting, with a fiscal and taxable year beginning on July 1 and ending on June 30. During its taxable year ending June 30, 1973, respondent purchased $150,199 worth of cattle feed for use in its dairy operations. In accordance with its cash method of accounting, it deducted the full cost of the feed from its gross income as a business expense on its 1973 return, even though a substantial portion of the feed had not yet been consumed by the end of that year (App. B, *infra*, 2a-3a).

On July 2, 1973, two days into the following taxable year, respondent adopted a plan of liquidation pursuant to Section 333 of the Internal Revenue Code of 1954. That provision allows the shareholders of a corporation, under certain conditions, to receive the corporation's assets during a one-month liquidation without recognizing gain or loss. During the month of July 1973, respondent distributed all of its assets to its shareholders *pro rata*. Among the assets so distributed was the unconsumed cattle feed that respondent had deducted as an expense in the preceding taxable year. Respondent's shareholders thereafter continued the dairy business. As a result of the liquidation, the shareholders acquired "stepped-up" tax bases in the feed, thereby allowing them the benefit of further deductions for the feed on their 1973 individual income tax returns (App. B, *infra*, 3a).

On audit of respondent's federal income tax return for its final taxable year (July 1, 1973—July 31, 1973), the Commissioner of Internal Revenue increased respondent's gross income by $60,000, representing the value of the unconsumed feed distributed to its shareholders. Respondent paid the resulting assessment, and brought this refund suit in the United States District Court for the District of Arizona. Although the district court agreed that the Commissioner's determination was correct, it considered itself bound by the Ninth Circuit's prior decision in *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (1963), and stated that it would follow that case "until such time as it is overruled" (App. A, *infra*, 1a).

The court of appeals affirmed on the authority of its prior decision in *South Lake Farms*. There it refused to apply the tax benefit rule in comparable circumstances involving the liquidation of a subsidiary corporation into its parent under Section 332 of the Code. In adhering to its decision in *South Lake Farms*, the court of appeals acknowledged that "[r]ecent decisions in the Courts of Appeals of other circuits are in conflict with our holding in *South Lake Farms*" (App. B, *infra*, 4a). See *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979); *First Trust & Savings Bank of Taylorville* v. *United States*, 614 F.2d 1142 (7th Cir. 1980); and *Hillsboro National Bank* v. *Commissioner*, 641 F.2d 529 (7th Cir. 1981), petition for cert. pending, No. 81-485.

REASONS FOR GRANTING THE PETITION

1. In holding that respondent was not required to include in income for the year of its liquidation an amount representing the value of the unused feed that it had deducted in the prior taxable year, the

court of appeals acknowledged that its decision conflicted with those of two other courts of appeals. In *Tennessee-Carolina*, *supra*, the Sixth Circuit held, in virtually identical circumstances, that the tax benefit rule (see pages 5-6, *infra*) required a liquidating corporation to include in gross income for the year of liquidation an amount equal to the value of property that was previously the subject of a tax deduction and that it distributed to its sole shareholder. In *First Trust* and *Hillsboro National Bank*, *supra*, the Seventh Circuit similarly held that the tax benefit rule required a corporation which had previously paid and deducted state property taxes imposed on its shareholders to restore the deduction to income in the year that the taxes were refunded to its shareholders.

The issue is both recurring and important to the administration of the revenue laws. Since 1978, controversies involving the application of the tax benefit rule in circumstances similar to those here or in *First Trust* and *Hillsboro National Bank* have been litigated six times.[1] We are, moreover, advised by the Internal Revenue Service that there are at least 15 cases pending at the appellate administrative level presenting the question, with $1,743,000 in income taxes at stake. This Court should resolve the conflict among the circuits in order to establish a uniform national rule.[2]

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[1] In addition to the instant case, and the cases cited above, see *Bonaire Development Co.* v. *Commissioner*, 76 T.C. 789 (1981), appeal pending, No. 81-7469 (9th Cir.); *Ballou Construction Co.* v. *United States*, No. 79-4138 (D. Kan. Aug. 4, 1981), appeal pending, No. 81-2155 (10th Cir.).

[2] Because the petition for a writ of certiorari in *Hillsboro National Bank* (No. 81-485) presents the same legal question in a different factual context, we are not opposing that petition

2.a. One of the fundamental principles upon which the federal system of income taxation is based is the annual accounting system. See Section 441 of the Internal Revenue Code of 1954; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931). As this Court stated in *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384 (1961): "It is settled that each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year."

The annual accounting system draws arbitrary lines between taxable years. As a result, situations necessarily arise in which the taxpayer may be required to report income or may be entitled to claim deductions for a particular year even though events occurring in a subsequent year may affect the amount of income actually enjoyed or the liabilities or losses ultimately incurred. The proper remedy for taking account of such changed circumstances is not to amend or modify the original return, but rather to reflect the change on the return covering the later period during which the correcting transaction actually occurred. See, *e.g.*, *Burnet* v. *Sanford & Brooks Co.*, *supra*, 282 U.S. at 365; *Healy* v. *Commissioner*, 345 U.S. 278 (1953).

One of the principles developed by the courts to deal with such subsequent year reportings is the "tax benefit rule," which is designed to ensure a measure of tax parity in the effect of an earlier deduction and later correcting return. Under the tax

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but suggest that the Court may wish to consolidate this case and *Hillsboro National Bank* for briefing and oral argument. We are serving a copy of this petition on counsel for the petitioner in No. 81-485.

benefit rule, the required correction for expenses that are deducted but not ultimately incurred is for income in the later year to be increased by the amount of the prior deduction.[3] *Rosen* v. *Commissioner*, 611 F.2d 942, 943 (1st Cir. 1980).

Here, respondent employed a method of accounting under which the cost of acquiring cattle feed was currently deducted as an expense without regard to whether it was fully consumed in the year of acquisition.[4] At the time of its liquidation, respondent held approximately $60,000 worth of cattle feed, for which it had previously claimed a business expense deduction. As a result of the liquidation, the unused feed was distributed to its shareholders who thereafter continued to engage in the dairy business. Having acquired "stepped-up" tax bases in the feed, the shareholders took further tax deductions for the feed on their individual income tax returns for 1973.[5]

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[3] While the "tax benefit rule" originated as a judicially devised principle of general application, it has received statutory recognition in the form of the provisions now set forth in Section 111 of the Code. That statute, however, does not, by its terms, codify the rule itself, but serves only to limit the amount of subsequent inclusion to that portion of the prior tax deduction that led to an actual tax benefit. See H.R. Rep. No. 2333, 77th Cong., 2d Sess. 45 (1942).

[4] This accounting method is based upon the premise that such a system of reporting would not result in a distortion of income. In an on-going dairy business, these types of expenditures will necessarily be made in roughly equal amounts from year to year. In these circumstances, the taxpayer is not required to match its deductions with actual usage through the use of inventory accounting.

[5] Respondent was liquidated pursuant to Section 333 of the Code, which generally provides that if the shareholders so elect and the liquidation is accomplished within one month, then the shareholders may receive liquidating distributions

The tax benefit rule requires that respondent's gross income for its final taxable year be increased by an amount equal to that portion of the prior deduction attributable to the unconsumed feed distributed to its shareholders. Although respondent properly deducted the cost of the feed in the previous taxable year when it was purchased, that deduction was premised on the assumption that the feed would, in fact, be consumed in respondent's trade or business within a relatively short period and that no substantial distortion of income would result even though some portion might not be consumed until a later taxable year. But that factual assumption proved to be unwarranted. Instead, respondent discontinued its business before the feed was actually consumed. Once the business with respect to which respondent had taken a deduction of $150,199 came to an end as a result of the liquidation in July 1973, respondent had outstanding a deduction for feed which it in fact would never consume. The integrity of the annual accounting system therefore demands that the amount of the excess deduction should be included in respondent's gross income for the year of liquidation.

b. Although the court below adhered to its prior decision in *Commissioner* v. *South Lake Farms, Inc.*,

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tax-free. Section 334(c) of the Code provides, in such circumstances, that the shareholders' bases in their stock shall generally carry over to the property distributed to them in the liquidation. In the present case, these provisions permitted taxpayer's shareholders to increase the tax basis of the feed from zero at which it was carried on respondent's books to reflect a ratable portion of the basis in their stock. Hence, the shareholders were able to claim a deduction on their own returns equal to that "stepped-up" basis when the feed was consumed.

324 F.2d 837 (1963), the limitation imposed by that case upon the tax benefit rule has been rejected by the other courts of appeals that have considered the question.[6] In *Tennessee-Carolina Transportation*,

[6] It is in fact arguable that the discussion of the tax benefit rule in *South Lake Farms* is dicta. The only issues presented to the Tax Court in that case were (1) whether the Commissioner had the authority under Section 446(b) of the Code to require a corporation to change its accounting methods and to include an amount representing the value of growing crops in income for the year in which it distributed all its assets to its sole shareholder, and (2) whether, in the alternative, the Commissioner had the authority to deny a deduction for crop growing expenses under Section 482 of the Code. The Tax Court rejected both contentions, and the court of appeals affirmed, with one judge dissenting. The court held (324 F.2d at 838) that no method of accounting required a taxpayer to include the liquidation value of the unharvested crops in its gross income.

However, the court went on to observe, in a discussion that is not central to the holding, that the absence of an actual "recovery" of a previously expensed item in the form of the taxpayer's receipt of "money or property equal to the amount previously spent and deducted" precluded the application of the tax benefit rule in some circumstances (324 F.2d at 840). Although the court conceded that the prior deduction resulted in a "tax windfall" to the taxpayer and its former shareholders, it nevertheless concluded that the Code provisions dealing with the treatment of liquidation distributions (Sections 334, 336 and 337) indicated that Congress did not intend that a liquidating corporation be charged with additional income on the distribution of such property to its shareholders (324 F.2d at 840).

The Ninth Circuit itself has subsequently recognized that Section 336 of the Code is not a bar to the inclusion of an overstated prior deduction in income in the year of liquidation. In *Home Savings & Loan Association* v. *United States*, 514 F.2d 1199 (9th Cir. 1975), the stock in a savings and loan association was first purchased by another savings and loan associa-

Inc. v. *Commissioner*, *supra*, the taxpayer Service Lines, Inc., was engaged in the motor freight transportation business, and regularly purchased tires and tubes for use in that business. Because the tires and tubes had useful lives of only one year, the taxpayer was permitted to deduct their full cost at the time of purchase as a business expense. At the time of its liquidation, the taxpayer distributed the previously expensed tires and tubes, then worth approximately $36,000, to Tennessee-Carolina, which had recently acquired all of Service's stock. Pursuant to Section 334(b)(2) of the Code, Tennessee-Carolina claimed a "stepped-up" basis in those tires and tubes equal to their value at the time of distribution, and thereafter claimed business expense deductions in that amount when the tires and tubes were consumed.

On these virtually identical facts, both the Tax Court and the Sixth Circuit held that Service had to include the liquidation date value of the tires and tubes in its income under the tax benefit rule, not-

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tion, which thereafter liquidated the acquired association. The court held that the liquidated association was required to include in its income certain amounts it had deducted as additions to its bad debt reserve prior to the take-over and liquidation. At the time the liquidating corporation's assets were distributed to the acquiring parent corporation, it became clear that the projection of bad debt expenses inherent in the reserve account was overstated. The court viewed the liquidation and distribution as an event inconsistent with the former corporation's prior deductions for the reserves. Although the court stated in its opinion that it did not intend to impair the authority of *South Lake Farms* (514 F.2d at 1201 n.1), the holdings of *Home Savings & Loan*, on the one hand, and *South Lake Farms* and the present case, on the other, cannot fairly be reconciled. See *First Trust & Savings Bank of Taylorville* v. *United States*, *supra*, 614 F.2d 1146 n.5.

withstanding the nonrecognition provisions of Section 336. In so holding, the court of appeals stated (582 F.2d at 382): "The tax benefit rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept which is necessary for administration of the tax laws." Rejecting the contrary suggestion of *South Lake Farms*, the court concluded that "there need not be an actual physical 'recovery' of some tangible asset or sum in order to apply the tax benefit rule," but that the rule could properly be invoked "whenever there is an actual recovery of a previously deducted amount *or* when there is some other event inconsistent with that prior deduction" (*ibid.*; emphasis in original). See *Estate of Block* v. *Commissioner*, 39 B.T.A. 338, 340-341 (1939), aff'd, 111 F.2d 60 (7th Cir.), cert. denied, 311 U.S. 658 (1940). In the court's view, such an inconsistent event had occurred when the taxpayer ceased its operations and transferred to its parent valuable assets which thereby acquired a "stepped-up" basis even though they had previously been deducted in full on the theory that they would be "totally used up" by the taxpayer itself. 582 F.2d at 382.[7]

The Seventh Circuit, in *First Trust & Savings Bank of Taylorville* v. *United States*, *supra*, and *Hillsboro National Bank* v. *Commissioner*, *supra*, has likewise rejected the narrow view of the tax benefit

[7] The court further noted that even if some form of "recovery" must occur before the tax benefit rule may be applied, there was sufficient recovery on the conversion of the "zero basis" tires and tubes into valuable assets that could take a "stepped-up" basis on distribution, and that, at all events, an "actual recovery" occurred when Service exchanged those assets for stock that had an equivalent value at the time of the transfer (582 F.2d at 382).

rule taken by *South Lake Farms*. In each of those cases, the court ruled that a taxpayer-bank realized income under the tax benefit rule when personal property taxes it had paid on behalf of its shareholders and deducted from its federal income tax pursuant to Section 164(e) of the Code, were refunded to the shareholders themselves in the next year. In both cases, the court rejected the notion that the tax benefit rule cannot be applied unless the taxpayer itself recovers the deducted amount. It concluded that the amounts were includable in the bank's income because the refunds to the shareholders were events inconsistent with the bank's prior deduction of the taxes. See 614 F.2d at 1145-1146; 641 F.2d at 531.[8]

Contrary to the decision below and *South Lake Farms* to which it adhered, the Sixth and Seventh Circuits correctly analyzed the practicalities and economics that form the basis for the tax benefit rule. It may well be that the inconsistent event that ordinarily triggers application of the tax benefit rule is the actual recovery of a previously deducted amount. But that is not the only situation which calls for application of the tax benefit rule. The rule necessarily applies whenever subsequent events are factually inconsistent with the retention of previously claimed tax benefits. This can occur when the recovery of a previously deducted amount is secured by

[8] The Ninth Circuit itself in a recent case cited *First Trust* with approval. In *Unvert* v. *Commissioner*, 48 A.F.T.R. 2d ¶ 81-5225 (Sept. 14, 1981), the court ruled that a taxpayer had to include in income the amount of prepaid interest it recovered where it had deducted that amount in a prior taxable year. While there was an actual recovery in that case, the court apparently approved the broad formulation of the tax benefit rule set forth in *First Trust*.

related persons (as in *First Trust* and *Hillsboro National Bank*) or when there is a "step-up" in the basis of property that has previously been "expensed" but never actually used in the operation of the taxpayer's trade or business, as was the case here and in *Tennessee-Carolina*. In both of those instances, subsequent events undermine the factual basis of the prior year's treatment and are inconsistent with the retention of previously claimed tax benefits. Since the annual accounting system ordinarily precludes reopening of the prior year's return, it is appropriate that gross income be increased for the year in which events occur that demonstrate that a prior year's deduction is no longer justified.

3. As the Sixth Circuit recognized in *Tennessee-Carolina*, there is another reason why the tax benefit rule should be applied in the case of liquidating distributions of property the cost of which the distributing corporation has previously deducted as an ordinary and necessary business expense. The failure to apply the rule in that context results in a substantial disparity between the tax consequences flowing to the parties where property is sold by the liquidating corporation in a transaction under Section 337 and the tax consequence where the property is transferred instead directly to the shareholders in a liquidating distribution governed by Section 336. The provisions now contained in Section 337 were adopted in order to eliminate the disparity in the tax treatment of such transactions under this Court's prior decisions in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945), and *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950). See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A106 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 258-

259 (1954). Thus, just as Section 336 provides, as a general rule, that no gain or loss is recognized by the liquidating corporation on the distribution of property to shareholders on liquidation, Section 337 provides, as a general rule, that no gain or loss is to be recognized by the liquidating corporation on a sale of property pursuant to a qualifying plan of liquidation.

Despite the nonrecognition provisions of Section 337, however, the courts have consistently held that the tax benefit rule requires that a liquidating corporation that sells its assets pursuant to Section 337 include in gross income an amount equal to the value of those items it has previously "expensed." The leading precedent, in this regard, is *Commissioner* v. *Anders*, 414 F.2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969). There, a corporation that had engaged in the business of renting towels, clothing and certain other products was liquidated. Even though the rental items had useful lives which often extended into subsequent tax periods, as in the instant case and in *Tennessee-Carolina*, it claimed an immediate deduction of all amounts expended for those items. Accordingly, the corporation carried its rental materials on the books as fully expensed. Following the adoption of a plan of liquidation, all of its assets were sold and the proceeds were distributed to the shareholders in a transaction meeting the requirements of Section 337. The corporation took the position that the amount it realized on the sale of previously expensed rental items was tax-free under the nonrecognition provisions of that statute. The court, however, held that the tax benefit rule required the inclusion in income of the previously expensed items.

As the court stated (414 F.2d at 1287-1288; footnote omitted):

> The rental items in question had a zero basis and their cost had been fully expensed on purchase by Service in its Federal income tax returns and deductions were taken therefor by Service. * * * In view of Service's charging the full cost of the rental items to expense, the "* * * increment realized in this area over and beyond adjustment basis does not then represent any gain in capital or asset value." West Seattle National Bank of Seattle v. Commissioner, supra, 288 F.2d at 49. * * * We conclude that the logic of tax benefit principles applies here, despite various distinctions suggested between Service's case and existing tax benefit decisions. Under such principles the proceeds of the rental items should properly be treated as recoupment of the expense charges.

Accord, *Anders* v. *United States*, 462 F.2d 1147 (Ct. Cl.), cert. denied, 409 U.S. 1064 (1972); *Spitalny* v. *United States*, 430 F.2d 195 (9th Cir. 1970).

If the decision below is permitted to stand, a corporation may easily escape the consequences of the tax benefit rule simply by distributing its assets to its shareholders, who may then sell the assets or use them in a continuing business, taking a second deduction in the amount of the "stepped-up" basis claimed under Section 334. But this is just the type of disparity that Congress intended to end when it enacted Section 337 as part of the Internal Revenue Code of 1954. If that intent is to be fully effectuated, liquidations under both Sections 336 and 337 should be treated alike. See *Midland-Ross Corp.* v. *United States*, 485 F.2d 110, 114 (6th Cir. 1973); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.65 (4th ed. 1979).

Otherwise, the course set by the court below will "elevate form over substance by reviving technical differentiations put to rest in 1954 with the adoption of § 337." *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, *supra*, 582 F.2d at 383 (footnote omitted).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1981

Appendix

APPENDIX A

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA

Date 2/15/79

No. CIV 77-562 PHX CAM

BLISS DAIRY, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Filed February 16, 1979]

The Court having considered all submitted memoranda as well as the oral arguments of the parties hereby orders that the motion for summary judgment filed by the plaintiff is granted and the motion for summary judgment filed by the defendant is denied. The court finds that *Commissioner* v. *South Lakes Farm* is the controlling case in the 9th circuit but is aware of the decision in *Tennessee-Carolina Transportation* v. *Commissioner*. Although the court agrees with the *Tennessee-Carolina* decision it will follow the 9th circuit decision in *South Lakes Farm* until such time as it is overruled.

/s/ C. A. Muecke
C. A. MUECKE
United States District Judge

APPENDIX B

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 79-3318

BLISS DAIRY, INC., AN ARIZONA CORPORATION,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Argued and Submitted Feb. 11, 1981

Decided May 11, 1981

Appeal from the Order of the United States
District Court for the District of Arizona

Before FERGUSON and REINHARDT, Circuit Judges, and BONSAL,* District Judge.

PER CURIAM:

The Government appeals from an order of the United States District Court for the District of Arizona granting the motion of plaintiff Bliss Dairy, Inc. ("the corporation") for summary judgment. The sole issue presented in this appeal is whether the district court erred in refusing to apply the "tax benefit" rule to a distribution of assets of a corporation in liquidation pursuant to Sections 333 and 336 of the Internal Revenue Code of 1954 ("the Code").

The corporation was organized under Arizona law in 1971; as of July 1973, all outstanding shares were held by Mrs. Irene Bliss, her daughter, and her son-in-law. During its fiscal year ending on June 30,

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* Honorable Dudley B. Bonsal, United States Senior District Judge for the Southern District of New York, sitting by designation.

1973, the corporation paid $150,199 for cattle feed for use in its dairy operations, for which it claimed a full tax deduction on its 1973 return in accordance with its cash method of accounting.

On July 2, 1973, immediately after the commencement of its next fiscal year, the corporation adopted a plan of liquidation pursuant to Sections 333 and 336 of the Code. Accordingly, during the month of July 1973, the corporation distributed its assets to its shareholders in proportion to their ownership interest. Among the assets so distributed in accordance with the plan of liquidation was cattle feed valued at $56,565. The value of this feed had been deducted by the corporation in its preceding fiscal year. The shareholders, who continued to operate the dairy business, computed their basis in the feed pursuant to Section 334(c) of the Code and then claimed deductions on their 1973 individual income tax returns.

The Commissioner of Internal Revenue increased the corporation's gross income by $60,000 for its final fiscal year. The corporation paid this assessment and filed a suit for refund. The district court, feeling bound by our decision in *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), granted the corporation's motion for summary judgment. The Government appeals, and we affirm.

The district court correctly concluded that it was bound by our decision in *South Lake Farms, supra.* There, we declined to apply the tax benefit rule [1] to a

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[1] The tax benefit rule, which is of judicial origin, *see Alice Phelan Sullivan Corp.* v. *United States*, 381 F.2d 399, 402-03, 180 Ct.Cl. 659 (1967), and has been indirectly acknowledged in Section 111 of the Code, is to be applied when

liquidation pursuant to Sections 332 and 336 of the Code because the liquidating corporation received no economic benefit from the transfer of its assets to a successor corporation. South Lake Farms, Inc. ("South Lake") was engaged in farming. Another party, South Lake Farms, purchased all of the stock of South Lake with the intent of liquidating it. The purchase price of the stock reflected the value of certain expenses incurred in the preparation of crops by South Lake, which was then liquidated. The assets were distributed before the time of harvest. In its final tax return, South Lake deducted the expenses incurred in preparing the crops but reported no income in connection with the transfer of the crops, which were harvested after liquidation. We held that since the proceeds of the sale of the stock of South Lake went to its shareholders, South Lake itself received no benefit:

> "Nowhere in the Code do we find an intent that gains to the stockholders were to be attributed to the corporation, much less that they were to be treated as ordinary income to the corporation." *South Lake Farms, supra*, at 839.

As in *South Lake Farms*, here there was no sale of assets by the liquidated corporation; rather, assets were distributed to stockholders during liquidation. Accordingly, Section 336 of the Code prevents the recognition of the value of the distributed feed as income to Bliss Dairy, Inc.

Recent decisions in the Courts of Appeals of other circuits are in conflict with our holding in *South Lake Farms*. *See Tennessee-Carolina Transporta-*

---

an amount deducted from a taxpayer's gross income in one taxable year is recovered in a later year. The amount recovered must be included as income in the later year.

tion, Inc. v. *C. I. R.*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909, 99 S.Ct. 1219, 59 L.Ed.2d 457 (1979); *First Trust and Savings Bank of Taylorville* v. *United States*, 614 F.2d 1142 (7th Cir. 1980); *Hillsboro National Bank* v. *Commissioner*, 641 F.2d 529 (7th Cir. 1981). However, we adhere to our decision in *South Lake Farms*.

Accordingly, the judgment of the district court is AFFIRMED.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 79-3318

DC CV 77-562 CAM

BLISS DAIRY, INC., an Arizona corp.,
PLAINTIFF-APPELLEE,

vs.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT.

Appeal from the United States District Court
for the District of Arizona (Phoenix)

THIS CAUSE came on to be heard on the Transcript of the Record from the United States District Court for the District of ARIZONA (Phoenix) and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this Cause be, and hereby is affirmed.

Filed and entered May 11, 1981

APPENDIX D

UNITED STATES COURT OF APPEALS FOR THE NINTH DISTRICT

No. 79-3318

D.C. #CV 77-562-CAM

BLISS DAIRY, INC., an Arizona corporation,
PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

[Filed Jul. 31, 1981]

Before: FERGUSON and REINHARDT, Circuit Judges, and BONSAL,* District Judge.

ORDER

The panel as constituted in the above case has voted to deny the petition for rehearing. Judges Ferguson and Reinhardt voted to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for en banc rehearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

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* Hon. Dudley B. Bonsal, United States Senior District Judge for the Southern District of New York, sitting by designation.

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES.

(a) *General Rule.*—No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

* * * * *

SEC. 333. ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS.

(a) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which section 341(a) applies, if—

(1) the liquidation is made in pursuance of a plan of liquidation adopted on or after June 22, 1954, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

* * * * *

(e) *Noncorporate Shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(1) there shall be recognized, and treated as a dividend, so much of the gain

as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

* * * * *

(c) *Property Received in Liquidation Under Section 333.—If—*

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition—

(A) gain was realized, but

(B) as the result of an election made by the shareholder under section 333, the ex-

tent to which gain was recognized was determined under section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him.

SEC. 336. DISTRIBUTIONS OF PROPERTY IN LIQUIDATION.

General Rule.—Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

* * * * *

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Opposition

Office - Supreme Court
FILED
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ALEXANDER

No. 81-930

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

UNITED STATES OF AMERICA, PETITIONER

V.

BLISS DAIRY, INC.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

No. 81-930

UNITED STATES OF AMERICA

v.

BLISS DAIRY, INC.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

OPINION BELOW

The opinion of the Court of Appeals is reported at 645 F.2d 19.

JURISDICTION

The judgment of the Court of Appeals was entered on May 11, 1981. The order denying the Government's petition for rehearing was entered on July 31, 1981. By order dated October 21, 1981, Justice Rehnquist extended the time in which the Government could file a petition for a writ of certiorari to and including November 21, 1981.

QUESTIONS PRESENTED FOR REVIEW

Whether the "tax benefit rule" applies to corporate liquidations held pursuant to the provisions of sections 333 and 336 of the Internal Revenue Code of 1954, as amended.

The Respondent takes exception to the Petitioner's statement of the Question Presented at page (i) of the Petition inasmuch as the Petitioner states that the shareholders in this case received a "stepped-up" basis in the assets they received upon liquidation of the corporation. Their basis in the assets received was determined pursuant to the provision of Section 334(c) of the Internal Revenue Code of 1954, as amended (28 U.S.C.), and Treasury Regulation 1.334-2. That provision of law and the regulation provides, generally, for the basis in the assets to equal the shareholders' basis in the stock of the corporation, increased by the corporate liabilities they assume. This is similar to a "carry-over" basis since their basis in the stock of the corporation carries over to the assets.

STATUTES INVOLVED

The relevant provisions of Sections 332, 333, 334, 336 and 337 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in App. A, infra, 1a.

STATEMENT OF CASE

The respondent corporation was organized under the laws of the State of Arizona on July 1, 1971, and it at all times was engaged in the business of operating a dairy. The corporation regularly kept its books and filed its income tax returns on the basis of the cash method of accounting with a fiscal year beginning on July 1 and ending on June 30, except for its final fiscal year which began on July 1, 1973 and ended July 31, 1973.

During the fiscal year ending June 30, 1973, the corporation purchased $150,000 worth of cattle feed for use in its dairy operation. The corporation, utilizing the cash method of accounting, properly deducted $150,000 worth of cattle feed as a business expense on its income tax return for the fiscal year ending June 30, 1973.

On July 2, 1973, the corporation adopted a plan of liquidation pursuant to Sections 333 and 336 of the Internal Revenue Code of 1954, as amended. During the month of July, 1973, and in accordance with the plan of liquidation which the corporation adopted, its assets, including unused cattle feed having a value of approximately $56,000.00, were distributed to the corporation's shareholders in proportion to their interest in the corporation. The shareholders' basis in the assets received was determined under Section 334(c) of the Internal Revenue Code of 1954, as amended, and Treasury Regulation Section 1.334-2 (App. B, infra). The corporation's liabilities were also distributed to and assumed by the shareholders.

The Commissioner, in applying the tax benefit rule, increased the corporation's gross income by $60,000 for its final fiscal year. The corporation paid the assessment and filed suit for refund of the tax paid. The case was heard in the United States District Court for the District of Arizona on cross motions for summary judgment and that Court followed the decision in Commissioner vs. South Lake Farms, Inc., 324 F.2d 837

(1963), which held that under section 336 the liquidating corporation received nothing in the transaction, there was no recovery and therefore the tax benefit rule did not apply. Accordingly, the District Court granted the corporation's motion for summary judgment and an order thereafter was entered for the corporation. The Government then brought an appeal on this case in the United States Court of Appeals for the Ninth Circuit. The judgment of the Court of Appeals was entered on May 11, 1981, affirming the decision of the Court below.

ARGUMENT

1. The Petitioner correctly states that the United States Court of Appeals for the Ninth Circuit acknowledged that its decision conflicted with those of two other Courts of Appeals; however, the Petitioner did not stress the fact that the Court of Appeals found satisfaction in its decision in Section 336 of the Internal Revenue Code of 1954, as amended (28 U.S.C.) (hereinafter referred to by Section), which specifically states that except as provided in Section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution

of property in partial or complete liquidation. In the case of a liquidation under Code Sections 333 and 336, the liquidated corporation receives absolutely nothing in the transaction; therefore, it is impossible for it to be said that the corporation recovered the amounts previously deducted.

The Petitioner also relies on the First Trust & Savings Bank of Taylorville v. United States, 614 F.2d 1142 (7th Cir. 1980) and Hillsboro National Bank v. Commissioner, 641 F.2d 529 (7th Cir. 1981), petition for cert. pending, No. 81-485, cases, which are readily distinguishable inasmuch as it can be argued that there truly was an economic benefit to the taxpayer, or its shareholders, derived from such transactions. Those cases did not, however, involve liquidations but rather deductions that were taken by the taxpayer for amounts paid in taxes, which taxes were subsequently refunded to its shareholders.

While the Respondent contends that the statute is clear on its face, it is submitted that additional legislation would be more appropriate than submitting this case for additional judicial determination.

Petitioner is, in effect, asking this Court to make exceptions to a specific statute where no such exception exists within the Internal Revenue Code. Additional legislation would, obviously, result only if it could be shown that there was an economic benefit derived in the situation at hand.

2.a. While Petitioner speaks of the application of the "tax benefit rule", it has failed to adequately review the situation involved in this case in determining if benefits were actually derived. The Petitioner indicates that as a result of the liquidation of the corporation, the shareholders were able to obtain "further tax deductions" for items that were already deducted by the corporation. Such logic fails on very basic points.

The general effect of a liquidation under Section 333 is to allow the receipt by qualified electing shareholders of property that has appreciated in value without the recognition of gain on such appreciation at the time of liquidation. However, gain may be recognized to the shareholders if the liquidating corporation has earnings and profits, or if it distributes money, stock, or securities. The purpose of Section 333 is to

permit corporations holding appreciated property but having no earnings and profits or cash, to be liquidated without the recognition of gain by the shareholders at the time of liquidation. The "gain" in appreciation to the shareholders at the time of liquidation goes unrecognized at that time except to the extent that a particular distribution is treated as a dividend to the shareholders. Section 333 is not all that glamorous inasmuch as the shareholder must determine his basis in the property received under the provisions of Section 334(c). The price the shareholder pays for the nonrecognition of gain in a Section 333 liquidation is that his bases in the assets distributed to him in liquidation will be low due to the nonrecognition of gain. Thus, upon sale of the assets, the shareholders must recognize gain computed on a low basis. Further, there is no sale that would result in a benefit to the corporation, but the corporation merely exchanges assets for all of its stock and ceases to exist.

The government has taken the position throughout the case that the shareholders received a "stepped-up" basis in the assets that they received from the corporation in liquidation pursuant to Section 333

which, in effect, would result in a benefit to the shareholders. Apparently, the government has taken the position that the shareholders are allowed to deduct the same item twice. A concise reading of Section 334 and the regulations promulgated thereunder, however, clearly reflects that the shareholders did not receive a "stepped-up" basis, but rather their basis in the assets was the same as their basis in the stock of the corporation adjusted by the liabilities of the corporation that they assumed. In essence, they are not writing off the cost of an asset that has already been written off by a corporation, but they are writing off their basis in the stock and the liabilities of the corporation that they assumed, inasmuch as these are items are utilized in determining their basis in the assets that they received from the corporation. If the shareholders had not had a basis in the stock and they had not had any liabilities to assume, they would not, obviously, be able to write off any amounts.

The Petitioner relies on the case of Tennessee-Carolina Transportation, Inc. v. Commissioner, 582 F.2d 387 (6th Cir. 1978) cert. denied 440 U.S. 909

(1979) stating that Respondent in this case or its shareholders received some "benefits" as a result of the liquidation. In the Tennessee-Carolina case, a subsidiary corporation was liquidated pursuant to the provisions of Section 332 and the basis of the assets received by the surviving corporation, its shareholder, was determined pursuant to the provisions of Section 334(b)(2).

Section 334(b)(2) is a codification of the result achieved in the Kimball-Diamond Mining Co. v. Commissioner, 187 F.2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951), wherein a corporation purchased the stock of another corporation and upon liquidation of the subsidiary into the parent, the basis in the assets was determined to be the amount that the surviving corporation paid for the stock rather than the basis that the liquidated corporation had in the assets. The logic in that case was that the parent corporation was actually purchasing assets rather than stock and, therefore, the basis in the assets was equal to the purchase price of the stock. In such situations the parent corporation is said to have received a "stepped-up" basis in the assets since the basis in the assets that the liquidated corporation

had is stepped-up to equal the purchase price of such stock. This is a similar situation to that in Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963). It could possibly be argued that there is some economic benefit involved in such a transaction inasmuch as there may have been a difference in the basis that the liquidated corporation had in its assets and the purchase price paid for its stock by the surviving corporation. That difference, if any, could possibly be considered to be gain that goes unrecognized. This case differs from both the Tennessee-Carolina case and the South Lake Farms case inasmuch as that situation does not exist. The shareholders in this case determined their basis in the stock of the Respondent corporation pursuant to Section 358, that is, the basis they had in the assets that were transferred to the corporation in the formation of the corporation. Upon liquidation, their basis in the assets received was determined by a reversal of the process, that is, their basis in the stock became their basis in the assets, subject to adjustments for the liabilities assumed. The so-called "stepped-up" that occurs when basis is determined under Section 334(b)(2)

did not exist. The shareholders in this case were only writing off, by depreciation of expense, assets with a basis equal to their basis in the stock of the liquidated corporation plus the liabilities that they assumed.

The Petitioner has sought to show that there was some benefit to the corporation in the liquidation inasmuch as there was an economic benefit derived by the shareholders. This economic benefit does not exist inasmuch as the shareholders are able to write items off only as a result of their investment or the liabilities that they assumed.

2.b. The case of Tennessee-Carolina Transportation, Inc. v. Commissioner, 582 F.2d 387 (6th Cir. 1978) cert. denied, 440 U.S. 909 (1979) is a case relied upon by the government which is in conflict with Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963) upon which the Ninth Circuit decided this case. The Sixth Circuit affirmed the United States Tax Court in finding that the tax benefit rule applied to corporate liquidations governed by Code Sections 334(b)(2) and 336. That Court rejected the taxpayer's contentions inasmuch as it felt that such contentions

would produce an unnecessary disparity between liquidations governed by Code Section 336 and those governed by Section 337. In support of its position, the Court stated that Section "336 liquidations are to be treated like Section 337 liquidations as a general rule unless some particular provisions of 337 justifies disparate treatment" Tennessee-Carolina, supra, p. 381. There is, however, a definite distinction in the various types of liquidations. In the lower court decision (Tennessee-Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440) Judge Tannenwald took the opportunity, in his scathing dissent, to compare Sections 336 and 337. Following his discussion of the legislative history of Section 337, he stated that "[b]y way of contrast, Section 336 represented a legislative confirmation of the long-standing judicial doctrine that a corporation generally does not recognize income from a distribution of its assets in kind to its shareholders."

It is respectfully submitted that the Ninth Circuit decision is a correct analysis that there are no economic benefits that merit the application of the tax benefit rule to a liquidation under Section 333.

3. Matters discussed in this portion of the Petition have been discussed in prior portions of the Respondent's Argument. Suffice it to say, in this case there is no escape of the tax benefit rule by the shareholders inasmuch as there is truly not a double deduction as a result of the liquidation involved in this case.

The decision of the Ninth Circuit is correct since there was no economic benefit to the corporation or the shareholders upon the liquidation that would require the application of the tax benefit rule.

CONCLUSION

For the reasons stated, it is respectfully submitted that the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

JAMES SILHASEK
Counsel for Respondent

January, 1982

APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES

(a) General Rule. - No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

* * * * *

SEC. 333. ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS.

(a) General Rule. - In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which Section 341(a) applies, if --

(1) the liquidation is made in pursuance of a plan of liquidation adopted on or after June 22, 1954, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the

liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

* * * * *

(e) Noncorporate Shareholders. - In the case of a qualified electing shareholder other than a corporation --

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such

month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

(a) General Rule. - If property is received in a distribution in partial or complete liquidation (other than a distribution to which Section 333 applies), and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair

market value of such property at the time of the distribution.

(b) Liquidation of Subsidiary. -

(1) In General. - If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of Section 332(b)), then, except as provided in paragraph (2), the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor. If property is received by a corporation in a transfer to which Section 332(c) applies, and if paragraph (2) of this subsection does not apply, then the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

(2) Exception. - If property is received by a corporation in a distribution in complete liquidation of another corporation

(within the meaning of Section 332(b)), and if -

(A) the distribution is pursuant to a plan of liquidation adopted not more than two years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and

(B) stock of the distributing corporation possessing at least eighty percent of the total combined voting power of all classes of stock entitled to vote, and at least eighty percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was acquired by the distributee by purchase (as defined in paragraph (3)) during a 12-month period beginning with the earlier of -

(i) the date of the first acquisition by purchase of such stock, or

(ii) if any such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under Section 318(a) as owning stock owned by the corporation from which such acquisition was made.

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any stock shall be

made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

(3) Purchase defined. - For purposes of paragraph (2)(B), the term "purchase" means any acquisition of stock, but only if --

(A) the basis of the stock in the hands of the distributee is not determined (i) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (ii) under Section 1014(a) (relating to property acquired from a decedent),

(B) the stock is not acquired in an exchange to which Section 351 applies, and

(C) the stock is not acquired from a person the ownership of whose stock would, under Section 318(a), be attributed to the person acquiring such stock.

Notwithstanding subparagraph (C) of this paragraph, for purposes of paragraph (2)(B), the term "purchase" also means an acquisition of stock from a corporation when ownership of such stock would be attributed under Section 318(a) to the person acquiring such stock, if the stock of such corporation by reason of which such ownership would be attributed was acquired by purchase (within the meaning of the preceding sentence).

(4) Distributee defined. - For purposes of this subsection, the term "distributee" means only the corporation which meets the eighty percent stock ownership requirements specified in Section 332(b).

(c) Property Received in Liquidation Under Section 333. If -

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition -

(A) gain was realized, but

(B) as a result of an election made by the shareholder under Section 333, the extent to which gain was recognized was determined under Section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the

liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him.

SEC. 336. DISTRIBUTIONS OF PROPERTY IN LIQUIDAITON.

General Rule. - Except as provided in Section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) General Rule. - If -

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete

liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

* * * * *

APPENDIX B

Treasury Regulation §1.334-2:

Property received in liquidation under Section 333.

The basis of assets (other than money) acquired by stockholders in a liquidation upon which the amount of gain recognized was limited under Section 333 shall be the same as the basis of the shares of stock redeemed or cancelled, decreased in the amount of any money received and increased in the amount of gain recognized and the amount of the unsecured liabilities assumed by the stockholders. The amount thus arrived at should be allocated to the various assets received on the basis of their net fair market values (the net fair market value of an asset is its fair market value less any specific mortgage or pledge to which it is subject). To that portion of the basis thus determined, for each property against which there is a lien, should be added the amount of such lien. Where more than one property is covered by the same lien, the amount of the lien should be divided among the properties, allocating to each that portion of the lien that the fair market value of such

property bears to the total market vlaue of the properties covered by the same lien. Whether the mortgage indebtedness is assumed by the shareholders of the property is taken subject to the mortgage is immaterial. The application of this section may be illustrated by the following example:

Example. The X Corporation distributed all its property in complete liquidation during the month of October 1954 pursuant ot the provisions of Section 333. A, an individual, and a qualifying electing shareholder, received, in cancellation or redemption of 100 shares of stock owned by him at the time of the adoption of the plan of liquidation, $1,000.00 in cash, property (other than stock or securities acquired by the corporation after December 31, 1953) with a fair market value of $22,000.00 subject to a lien of $1,000.00, and stock acquired by the liquidating corporation after December 31, 1953 with a fair market value of $4,000.00. A also assumed a $2,000.00 liability of the liquidating corporation. The basis of the shares owned by A was $120.00 per share or $12,000.00. A's ratable share of the

earnings and profits of the X Corporation accumulated after February 28, 1913 (computed as provided in Section 333) was $2,500.00. His gain is $12,000.00, but under Section 333 only $5,000.00 of this gain is recognized, $2,500.00 thereof being taxed as a dividend. The basis of all the property other than money received by A is $19,000, computed as follows:

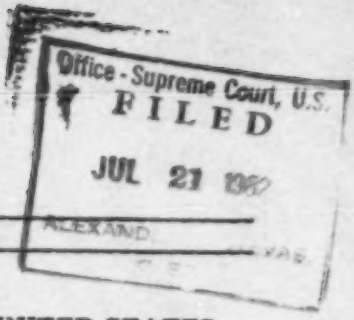
Adjusted basis of stock cancelled or redeemed	$12,000
Less: money received	1,000
Remainder	11,000
Liability assumed	2,000
Specific lien against property (other than stock)	1,000
Gain recognized	5,000
Basis of property acquired	19,000

The basis, excluding the specific lien attached to the property ($19,000.00) less $1,000.00, $18,000.00), will be apportioned among the classes of property other than money received as follows: $21,000.00/$25,000.00 of $18,000.00 or $15,120.00 to the property other than stock; $4,000.00/$25,000.00 of $18,000.00 or $2,880.00 to the stock. The basis of the property other than stock, $15,120.00, must be increased by the amount of the

specific lien attached thereto, $1,000.00, making a total basis for such property of $16,120.00.

Respondent's Brief

No. 81-930



IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

UNITED STATES OF AMERICA

v.

BLISS DAIRY, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTIONS PRESENTED

Whether a corporation liquidated pursuant to the provisions of Sections 333 and 336 of the Internal Revenue Code of 1954, as amended, is, under the tax benefit rule, required upon liquidation to include in income a portion of an amount previously and properly expensed, where there was no actual recovery of the item expensed by the corporation, where the distributee shareholders received a basis in the assets equal to their basis in the stock of the corporation, with adjustments, and where the statute specifically states that no gain or loss shall be recognized to a corporation on distribution of property in liquidation.

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BLISS DAIRY, INC.

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BRIEF FOR THE RESPONDENT

STATEMENT OF CASE

Respondent Bliss Dairy, Inc., was a corporation organized and existing under the laws of the State of Arizona and throughout its entire period of existence was engaged in the business of operating a dairy. The corporation kept its books and filed its Federal income tax returns on the basis of a cash method of accounting. Its fiscal year began on July 1 and ended on June 30,

except for its final fiscal year which began on July 1, 1973, and ended on July 31, 1973.

Throughout the fiscal year beginning July 1, 1972, and ending June 30, 1973, the corporation made purchases of cattle feed totalling $150,199.00 for use in its dairy operation. The corporation, in accordance with the cash method of accounting, properly deducted the amount expended for cattle feed as a business expense on its tax return filed for the fiscal year ending June 30, 1973. There is no question as to the validity of the deduction or that it was properly treated.

During the fiscal year beginning July 1, 1973, specifically on July 2, 1973, the corporation adopted a plan of liquidation pursuant to the provisions of Sections 333 and 336 of the Internal Revenue Code of 1954, as amended. Under the provisions of Code Section 333, the corporation was required to cancel or redeem all of its stock and distribute all of its assets to its shareholders within one calendar month. During the month of July, 1973, and in compliance with the statute, the corporation distributed all of its assets to its shareholders in redemption of all of the stock of the corporation and

went out of business. Included in the assets distributed was unused cattle feed, having a fair market value of approximately $56,000.00. During the final fiscal year of the corporation's existence, there was no sale of assets, nor did the corporation receive a tax refund or credit relating to the amount paid for the assets distributed that had been previously expensed.

As a result of the liquidation, the shareholders of the corporation received the assets with their bases being determined by Code Section 334(c). The bases was not the fair market value of the assets received, or a "stepped-up" bases, but was the bases that they had in the stock of the corporation, subject to adjustments as required by the statute and regulations promulgated thereunder. While it is true that the assets were available for deduction by the shareholders, the amount available for deduction was in no way based on the fair market value of the assets received. The deductions available to the shareholders were limited to the bases that they had in the assets as determined by law. The amount of the shareholders deductions included amounts that they had paid or were required to pay.

They did not receive a benefit as a result of the fact that the assets were previously deducted by the corporation.

Upon audit of the respondent's final Federal income tax return, the Commissioner of Internal Revenue increased the respondent's gross income by $60,000.00 and asserted a deficiency in income tax in the amount of $28,800.00. The corporation paid the assessment, together with statutory interest, and filed suit for refund of the amounts paid in the United States District Court for the District of Arizona. The case was heard in the district court on Cross Motions for Summary Judgment and a decision was rendered in favor of the respondent. The United States appealed to the Court of Appeals for the Ninth Circuit, which affirmed the lower court's decision. The United States then filed a Petition for Certiorari which was granted on January 18, 1982.

SUMMARY OF ARGUMENT

As a result of the liquidation of the taxpayer, Bliss Dairy, Inc., it did not derive a tax benefit upon the distribution of its assets to its shareholders, the cost of such assets having been properly expensed by the tax-

payer in a prior tax year. The tax benefit rule provides that an item properly offset against income in determining the true liability for a particular tax year is includable in goss income by the taxpayer where it is recovered in a subsequent year. The tax benefit rule requires an actual recovery of an item that has produced an income tax benefit in a prior year. Nash v. United States, 390 U.S. 1 (1970). This Court has rejected the broad application of the tax benefit rule and has refused to adhere to a deemed or constructive recovery, in lieu of an actual recovery. The judicially recreated doctrine has been applied to various types of transactions, but only when there has been an actual recovery by the taxpayer. Further, the doctrine has been partially codified, but with the requirement that there be an actual recovery. Therefore, for the tax benefit rule to apply, there must be an actual recovery of a previous tax benefit derived by the taxpayer.

Following the liquidation of the taxpayer-corporation, the corporation simply distributed all of its assets in exchange for its stock, with the value of the stock upon the taxpayer's cessation of business and

distribution of property being nill. The corporation derived no recovery as a result of the liquidation.

The specific statute dealing with the type of liquidation under which the corporation was liquidated specifically states that no gain shall be recognized by the corporation upon distribution of its assets pursuant to the liquidation. Further, Congress has had the opportunity, on many occasions, to specifically consider amending the statute, but has rejected any amendment. Consequently, judicial determinations should not override the specific language of the statute where the intent of Congress is clear.

Although the Government contends that the liquidation of the corporation resulted in a double deduction, a review of the entire transaction, including the effect of the liquidation upon the shareholders of the corporation, clearly shows that there was no recovery by the corporation nor did the subsequent activities of the shareholders result in a double deduction.

ARGUMENT

THE TAX BENEFIT RULE DOES NOT APPLY TO CORPORATE LIQUIDATIONS HELD PURSUANT TO THE PROVISIONS OF SECTIONS 333 and 336 OF THE INTERNAL REVENUE CODE OF 1954, AS AMENDED.

A. The Tax Benefit Rule Requires A Recovery

The tax benefit rule provides that an item properly offset against gross income in determining the true liability for a particular year is includable in gross income where it is recovered in a subsequent year. Alice Phalen Sullivan Corp. v. United States, 381 F.2d 399, 401-402 (Ct. Cl. 1967). The principal theory is that a taxpayer should return a benefit previously obtained.

The Internal Revenue Service has attempted to apply this judicially created doctrine to several areas. One area involves the transfer of accounts receivable to a controlled corporation in a transaction that would normally qualify for nonrecognition of gain or loss under Code Section 351. While the Commissioner experienced early success in applying the tax benefit rule to such transactions where there was actually no economic

recovery, the Supreme Court in Nash v. United States, 398 U.S. 1, 3 (1970), held that the tax benefit rule provides that a "recovery of an item that has produced an income tax benefit in a prior year is to be added to income in the year of recovery." (Emphasis supplied) In the Nash case, a partnership on the accural method of accounting transferred its assets to a new corporation pursuant to a transfer under Code Section 351. The Commissioner argued that the partnership should have included in income the amount of bad debt reserve on the grounds that upon transfer of the receivables, the partnership no longer had a "need" for the reserve under the amounts previously charged that reserve and such amounts should, therefore, be restored to income. The Court held that the taxpayer was not required to "recover" the reserve, emphasizing the fact that the value of the securities which were received in exchange for the receivables did not exceed the net value of the receivables. Accordingly, the taxpayer received no benefit which would require recovery of the amounts previously charged off as bad debts.

In delivering the opinion of the Supreme Court, Justice Douglas stated that:

> Congress could make the end of "need" synonymous with "recovery" in the meaning of the tax benefit rule and make the rule read: "a bad debt reserve which has produced an income tax benefit in a prior year is to be added to income in the year when it was recovered or when its need is ended." The semantics would then be honored by the Commissioner's ruling. But we do not feel free to state the tax benefit rule in those terms in the present context. We deal with Section 351(a) of the Code which provides:
>
> > "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control ... of the corporation."
>
> All that petitioners received from the corporations were securities equal in value to the net worth of the accounts transferred, that is the face value less the amount of the reserve for bad debts. If, as conceded, there is no "gain" or "loss" recognized as a result of the transaction, it seems anomolous to treat the bad debt reserve as "income" to the transferor (398 U.S. at 3 and 4).

The opinion goes on to point out that the Court of Appeals for the Ninth Circuit in the case of Estate of Schmidt v. Commissioner, 355 F.2d 111 (9th Cir. 1966), was correct in holding that although the "need" for the

reserve ended with the transfer, the end of the "need" did not mark "recovery" within the meaning of the tax benefit cases. Nash v. United States, 398 U.S. at 5.

The Supreme Court rejected the use of such a broad application of the tax benefit rule and refused to supply a "deemed" or "constructive" recovery, but instead required an actual recovery, indicating an abandonment of the use of fictions in applying the tax benefit rule. In rendering the Nash decision, the Court disapproved a number of prior cases holding that the entire amount of a bad debt reserve should in every case be restored to income in a Code Section 351 transfer under an expanded view of the tax benefit rule in which a cessession of the "need" for a bad debt reserve was considered to supply the necessary recovery. Schuster v. Commissioner, 50 T.C. 98 (1968); Hutton v. Commissioner, 53 T.C. 37 (1969) rev'd per curiam, 434 F.2d 1313 (6th Cir. 1971).

The Government is apparently attempting to resurrect its argument in the Nash case at pages 17 and 18 of its Opening Brief by discussing the "inclusionary aspects" of the tax benefit rule. The contention that the

rule "requires restoration to income of a previously deducted expense when subsequent events eliminate the factual premise on which the deduction was originally claimed" is asserting, again, that the end of 'need' is synonymous with 'recovery'. That contention has been laid to rest in Nash.

A second line of cases involves the application of the tax benefit rule to preliquidation sales of property under Code Section 337. Under Code Section 337, there is no gain or loss on sales or exchanges of corporate property that occur within a twelve month period following the adoption of a plan of complete liquidation and prior to the liquidation of the corporation provided the corporation distributes all of its assets within the twelve month period in complete liquidation. Code Section 162 of the Code permits taxpayers to deduct currently, rather than capitalize, the cost of property having relatively short useful lives. The question arises as to the application of the tax benefit rule to those items which had been previously expensed but which have value at the time a Code Section 337 liquidation occurs. In Anders v. Commissioner, 48 T.C.

815 (1967), the taxpayer had been engaged in the business of providing a rental service for laundered shirts, towels, seat covers, pants and other items. In addition, the taxpayer conducted a laundry service for such items owned by others. Pursuant to Code Section 162, the taxpayer deducted the cost of the rental items used in its business. The taxpayer then adopted a plan of pursuant to the provisions of Code Section 337 and, within the required twelve month period, the taxpayer sold its assets prior to the liquidating distribution. Approximately one-half of the gain realized on the sale of assets was attributable to the sale of items previously expensed. The Commissioner took the position that the tax benefit rule overrode the non-recognition provisions of Code Section 337 with respect to the sales prior to liquidation and asserted deficiencies. The Tax Court held for the taxpayers but this decision was reversed by the Tenth Circuit. Commissioner v. Anders, 414 F.2d 1283 (10th Cir. 1969), cert. denied, 396 U.S. 958 1969). In Anders, the taxpayer received a recovery in cash for the property that was previously deducted. The basic issue was whether or not the tax benefit rule will

override the provisions of Code Section 337 with respect to sales prior to liquidation. This case did not involve the application of the tax benefit rule to a distribution upon liquidation. The Court concluded its opinion by stating that "the recoupment of the charges involved here reasonably comes within the tax benefit principals in similar cases, and Section 337 does not alter or bar their application. In these circumstances, we do not believe that treatment as a non-recognizable gain was intended by Congress". (Emphasis supplied) Id. at 1288-9. The Court of Claims had the opportunity to consider the same issue for the United States Court of Appeals for the Tenth Circuit as a result of an individual taxpayer having transferee liability of the liquidated corporation. Anders v. United States, 462 F.2d 1147 (Ct. Cl. 1972), cert. denied, 409 U.S. 1064 (1972). The Court of Claims followed the rationale of the Tenth Circuit, dwelling on the fact that there was an actual recovery as a result of the sales prior to liquidation. The Tenth Circuit decision in Anders has been followed by the Ninth Circuit in the case of Spitalny v. United States, 438 F.2d 195 (9th Cir. 1970). In that case, [illegible]

corporation was involved in the cattle feeding business and had deducted the cost of feed as an expense under Section 162. Pursuant to a plan of liquidation, this previously expensed feed was sold. Again, it is clear that there was a present recovery by the taxpayer in Spitalny. Similar decisions have been reached by other courts in which the question has been the application of the tax benefit rule to preliquidation sales of previously expensed advertising items and parts and supplies. Connery v. United States, 26 A.F.T.R. 2d 70-5123 (D. N.J. 1969); S.E. Evans, Inc. v. United States, 317 F. Supp. 423 (W.D. Ark. 1970).

It must be stressed that these cases do not involve the application of the tax benefit rule to the liquidating distributions of the corporation, but rather to sales that occurred after a plan of liquidation had been adopted, but prior to the time that assets were actually distributed to the shareholders. Further, the court saw fit to override the specific statutory language because there was an economic recovery, finding no intent by Congress to limit its application.

The tax benefit rule has also been held applicable to a variety of instances in which expensed items were actually recovered, including recoveries of previously deducted bad debts Home Savings & Loan Assn. v. United States, 514 F.2d 1199 (9th Cir. 1975), cert. denied, 423 U.S. 1015 (1975); Arcadia Savings and Loan Association v. Commissioner, 300 F.2d 247 (9th Cir. 1962); West Seattle National Bank of Seattle v. Commissioner, 33 T.C. 341 (1959), aff'd, 288 F.2d 47 (9th Cir. 1961); Citizens Federal S & L Ass'n of Cleveland v. United States, 290 F.2d 932 (Ct. Cl. 1961); recoveries with respect to securities written off as worthless Dobson v. Commissioner, 321 U.S. 231 (1944); recoupment of taxes previously deducted Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir. 1940), cert. denied, 311 U.S. 658 (1940); reimbursements for guaranty and legal payments Goodman v. Helvering, 115 F.2d 242 (2d Cir. 1940); recoupment of losses under construction contracts Burnet v. Sanford & Books Co., 282 U.S. 359 (1931); insurance recoveries in subsequent years Valspar Corp. v. Commissioner, 5 T.C.M. 1110 (1946); Zeeman v.

United States, 275 F.Supp. 235 (1967), aff'd and remanded, 395 F.2d 861 (2d Cir. 1968).

It is important to note two points in reviewing all of these cases. First, in the cases which arose under Code Section 351, the Supreme Court refused to participate in a fiction in order to apply the tax benefit rule. Second, in all of the cases in which there was application of the tax benefit rule, the taxpayers had received an actual economic recovery.

The judicially created tax benefit rule has, to some extent, been codified under Code Section 111, which provides, in general, that the recovery of a previously deducted item is includable in income only if the original deduction resulted in a tax benefit. This section is, however, limited to bad debts, prior taxes and delinquent amounts to the extent that the prior deduction did result in a tax benefit to the taxpayer. The regulations promulgated under the statute define "recovery" as "receipt of amounts" in respect of the previously deducted or credited Code Section 111 item, such as from the collection or sale of a bad debt, refund or credit of taxes paid or cancellation of taxes accrued.

See Treas. Reg. Section 1.111(a)(2). There is, therefore, the requirement of an actual recovery of a prior tax benefit.

The position that there was a "recovery" in this case is directly contrary to the regulations promulgated by the Internal Revenue Service under Code Section 111 and judicial application of the tax benefit rule. As explained in Part C. of the Argument, the type of "recovery" intended is lacking in the instant case inasmuch as the corporation did not receive any "amounts in respect of" the previously deducted cattle feed. There was no sale of the cattle feed, nor was there a refund or credit of amounts paid for the cattle feed. The corporation simply distributed all of its assets, including the cattle feed, in kind, in complete liquidation and went out of existence. No authority has been discovered that would support the position that a distribution of property in liquidation represents a "recovery" under Code Section 111 or the cases cited. It appears to be inconsistent to extend a judicially created doctrine beyond the intent of Congress.

B. Legislative History And Effect Of Code Section 336

The corporation, Bliss Dairy, Inc., was liquidated pursuant to the provisions of Code Sections 333 and 336. The effect of Code Section 333 is discussed at a later point and discussion at this time is limited to the effect of a liquidation on a corporation by the application of Code Section 336.

Code Section 336, in effect for the period in question, is one of the shortest Code Sections in the Internal Revenue Code, taking up scarcely one inch of space in the Code. Code Section 336 provides in full:

> Except as provided in Section 453(d) (relating to disposition of an installment obligation), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

Further, the regulations under Code Section 336 provide in full:

> Except as provided in Section 453(d), no gain or losses recognized to a corporation on the distribution by it of property in partial or complete liquidation (regardless of the fact that such property may have appreciated or depreciated in value since acquisition by the corporation). However, gain or loss is recognized of the corporation on all sales by it, whether directly or indirectly (as though

> trustees or a receiver), except as provided in Section 337 (relating to sales or exchanges in connection with certain liquidations). See Sections 61, 6036, 6155(a), 6161(c), 6503(b), 6601, 6871, 6872 and 6873.

In a reading of this particular Code Section, together with the regulations thereunder, it is clear that the Congress intended, along with the concurrence of the Internal Revenue Service as reflected by its brief regulation, that there would be no gain to the corporation upon liquidation and distribution of its assets to its shareholders, except as specifically provided in Section 453(d) or if specifically provided for under other Code Sections. Code Section 453 provides certain instances where gain is recognized to the corporation under distribution of installment obligations. This requires a corporation to recognize gain that would otherwise be deferred for future years for the obvious reason that the corporation is now going out of existence. This is the same as if an existing corporation had decided to accept prepayment of an installment obligation. It would, of course, have to recognize gain in the year of acceptance, which gain otherwise would have been delayed. Additionally, the various "recapture" rules, such as Code Sections 47(a)(1),

1245 and 1250, require a liquidating corporation to include an appropriate amount in its tax liability or taxable income when property subject to the mentioned provisions is transferred. Again, this is a matter of either recapturing a tax credit or a deduction which the corporation was entitled to, provided it met certain requirements. By the early disposition of assets through liquidation, it had failed to meet the requirements and, therefore, was subject to the recapture provisions of those particular sections. Such recapture provisions are activated as a result of the early disposition of the property rather than the liquidation of the corporation and are specifically provided for by statute.

The plain language of the statute, however, states that there shall be no gain on the distribution of property in complete liquidation of the corporation. It is a long recognized principal that the words of statutes should be interpreted where possible in their ordinary and everyday meanings. Crane v. Commissioner, 331 U.S. 1 (1947). Here we have a simple statute which the Internal Revenue Service has sought to compliment by one paragraph of regulations that sets forth the effect

on the income of a corporation resulting from the liquidation of that corporation.

Although Code Section 336 first appeared in the 1954 Code, it was previously applied by Treasury Regulation 118, Section 39.22(a)-20 promulgated under the 1939 Code. The legislative history shows that when Congress enacted Section 336, it carefully considered under what circumstances there should be an exception to the general rule that no gain or loss is recognized to a liquidating corporation upon distribution in liquidation. Section 308 of the House version of the bill (H.R. 8300, 83d Cong., 2d Sess.) dealt generally with the tax consequences at the corporate level of distribution of stock, securities or property to the shareholder of a corporation, be they liquidating or nonliquidating distributions. The general rule in both cases was non-recognition of gain. While the House bill provided that under certain circumstances non-liquidating distributions by corporations would give rise to gain or loss, the bill made it clear that these exceptions would not apply to distributions in liquidation. See H.R. Rep. No. 1337, 83d

Cong., 2d Sess., U.S. Code Cong. and Ad. News 4228 (1954).

The Senate version of the 1954 Code contained separate sections dealing with the tax consequences to distributing corporations of corporate distributions: section 311 dealt with nonliquidating distributions, and section 336 with liquidating distributions. This statutory scheme was reflected in the 1954 Code as enacted and endures to the present day. Following the approach of the House, the Senate included in section 311 certain situations under which a corporation making a nonliquidating distribution of property to its shareholders will recognize gain, and these exceptions were not included in section 336. The Senate did, however, include an exception to the general nonrecognition rule of section 336 in the case of a liquidating distribution of installment obligations. See S. Rep. No. 1662, 83d Cong., 2d Sess., U.S. Code Cong. and Ad. News 4895 (1954). This exception was adopted in the 1954 Code as enacted and has remained a part of Section 336.

Since the passage of the 1954 Code, Congress has, on many occasions, considered the extent to which a

sale or other disposition of an item of property that previously gave rise to a deduction against ordinary income should result in ordinary income, even when the disposition is of the sort that would generally produce no gain or loss under nonrecognition provisions of the Code. In each case, Congress has been specific as to the circumstances of disposition under which previous deductions will be "recaptured" as ordinary income. For example, in the Revenue Act of 1962 (Pub. L. No. 87-834), Congress added Section 1245 to the Code, effective for taxable years beginning after December 31, 1962. Section 1245 provides generally for the "recapture" of depreciation deductions take with respect to personal property, i.e., upon the disposition of personal property, gain is ordinary income to the extent of prior depreciation deductions. Except in the precise and detailed circumstances delineated in Section 1245(b), Section 1245 applies notwithstanding any other provision of Subtitle A of the Code. See Code Section 1245(d). Thus, Section 1245 overrides the nonrecognition provisions of Section 336, except as provided in Code Section 1245(b).

Congress took similar pains to specify the scope of Section 1250, added to the Code by the Revenue Act of 1964 (Pub. L. No. 88-272), effective as to dispositions after December 31, 1963, in taxable years ending after such date, and providing generally for the recapture as ordinary income of "accelerated" depreciation (i.e., depreciation taken in excess of straight-line) upon the disposition of real property. Again, because Congress so provided, it is clear that Section 1250 overrides the nonrecognition provisions of Section 336. See Code Section 1250(i).

The attention given by Congress in defining exactly when the nonrecognition provisions of Code Section 336 will be overridden is well illustrated by its treatment of liquidating distributions of installment obligations. As noted, Code Section 336 itself provides that its nonrecognition rule will apply to the disposition of installment obligations only as specified in Code Section 453(d). Congress on numerous occasions has amended Code Section 453(d)(5) to specify precisely the circumstances under which, and the extent to which, a distribution of an installment obligation in liquidation

will result in taxable gain to the liquidating corporation. See P-H 1982 Fed. Taxes Code Vol. 25, 450.

The foregoing legislature history compels a rejection of the Commissioner's position in the instant case. It demonstrates that Congress has carefully considered, on many occasions, the issue of when a corporation will recognize gain or loss on a distribution of property in liquidation. Where Congress has intended to provide an exception to the general nonrecognition rule, it has done so. If there is a question as to the wisdom of the result reached from applying express statutory provisions, it is for Congress to resolve the matter, based on Congress' conception of proper tax policy. See Hanover Bank v. Commissioner, 369 U.S. 672, 687-88 (1962). The Congress has sought fit to limit its activities in this area and the courts should not "enter this thicket." Braunstein v. Commissioner, 374 U.S. 65, 73 (1963).

C. No Recovery By The Liquidated Corporation Or Benefit to Shareholders

The position of the corporation simply stated is that it received no consideration upon distribution of

its assets to its shareholders upon liquidation. The taxpayer received only its own stock in return for the distributed property, with the value of stock upon the taxpayer's cessation of business and distribution of property being nil. Since there was no receipt of consideration, the tax benefit rule has no application to this particular liquidation. Only the shareholders were in receipt of any consideration, that being receipt of assets in exchange for the stock that they held in the corporation.

The corporate liquidation under Code Sections 333 and 336 results in no present economic recovery or benefit to the liquidating corporation. Code Section 336 deals with the effect of the liquidation on the corporation while Code Section 333 deals with the effect of the liquidation of the shareholders with respect to the income they must recognize and Code Section 334 determines the basis that the shareholders have in the assets received.

In understanding the liquidation at hand, Code Sections 333 and 334 must be examined in conjunction with Section 336.

The initial predecessor of Section 333 was first enacted into law as a result of the Revenue Act of 1938. It was applicable only to corporate liquidation affected in December of 1938. See 3 P-H 1982 Fed. Taxes, par. 17, 675. Its original purpose was to permit the liquidation of personal holding companies that were subject to the penalty on undistributed earnings. H.R. Rep. No. 2087, 80th Cong., 2nd Sess. 26-26 and S. Rep. No. 2375, 81st Cong., 2nd Sess. 63.

Although originally enacted as a temporary expedient, the provision was periodically re-enacted. It was added to the 1939 Code, as Section 112(b)(7), by Section 120 of the 1943 Revenue Act and was made applicable to corporate liquidations effected in any one calendar month of 1944. Section 206(a) of the 1950 Act re-enacted the provision, making it applicable to 1951, in addition to 1944. It was made applicable to 1952 by Section 316(a) of the 1951 Act and to 1953 by Section 101(a) of the Technical Changes Act of 1953. 3 P-H 1982 Fed. Taxes, par. 17, 675. Finally, with the enactment of the 1954 Code, Section 333 was a permanent part of the law applicable to plans of liquidation adopted

after June 22, 1954. While the principal purpose for the enactment of Section 333 and its predecessors was to permit the liquidation of personal holding companies, it has never been limited to personal holding companies, but has been applicable to all corporations.

The effect of the statute may be explained by a simple example. Assuming that the only assets of a corporation were shares of stock of other corporations. If that corporation was, as a result of the law, classified as a personal holding company or suddenly subjected to personal holding company tax, it would be unfair to suddenly subject the corporation to an additional tax, when such was not anticipted at the time of its formation. To eliminate this inequity, the corporation could be liquidated, with the assets being distributed to the shareholders who would then be taxed on the earnings of the stock without the additional personal holding company tax. Even if the assets had appreciated in value, it would be unfair, and impossible, for the corporation to pay any tax since there would be no funds available to pay the tax - the corporation had no cash, just stock of other corporations. Under Sections 333 and 336, there is

no tax on the liquidation; however, as explained below, the shareholders' bases in the appreciated assets received are determined by their bases in the stock of the liquidating corporation. Upon resale of the appreciated assets received, the shareholders will pay tax on the gain, that being the difference between the amount received from the sale and their bases in the assets.

The general effect of Code Section 333 is to permit the receipt by qualified electing shareholders of property that has appreciated in value without the recognition of gain on such appreciation, provided that the assets are distributed within one calendar month. However, gain may be recognized by the shareholders if the liquidating corporation has earnings and profits, or if it distributes money, stock or securities. Application of the section generally means that only a portion of qualified electing shareholder's gain on liquidation is recognized; the balance is not taxed at the time of liquidation.

Section 333 provides, in part:

> (a) GENERAL RULE. In the case of property distributed in complete liquidation of a domestic corporation ... if

> (1) the liquidation is made in pursuance of plan of liquidation adopted, and
>
> (2) the distribution is complete cancellation or redemption of all the stock, then the transfer of all the property under the liquidation occurs within some one calendar month,
>
> then in the case of each qualified electing shareholder ... gain on the shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

The purpose of Code Section 333 is to permit a corporation holding appreciated property, but having no earnings and profits or cash, to be liquidated without the recognition of gain by the shareholders. The gain to the shareholders goes unrecognized at the time of liquidation except to the extent that a particular distribution is treated as a dividend to the shareholder. This particular dividend treatment precludes a bailout of earnings and profits.

The effect of Code Section 333 is not all that glamorous inasmuch as the shareholder must determine his basis in the property received under the provisions of Code Section 334(c). That subsection provides:

> (c) PROPERTY RECEIVED IN LIQUIDATION UNDER SECTION 333. - If -

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition -

(A) gain was realized, but

(B) as the result of an election made by the shareholder under Section 333, the extent to which gain was recognized was determined under Section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him." (Emphasis supplied)

The price the shareholder pays for the nonrecognition of gain in a Section 333 liquidation is that his basis for the assets distributed to him in the liquidation will be low due to the nonrecognition of gain. As is stated in Bittker and Eustice, Federal Taxation of Corporation, (4th ed., 1979, pg. 11-22):

In return for the nonrecognition of gain under Section 333, the Code exacts the usual price of nonrecognition: The shareholder's basis for the assets received on the liquidation is the same as his basis for the stock surrendered (adjusted if any gain was recognized), (Section 334(c)). On a sale of the assets (and assuming no later change in

> value), the shareholders will recognize the gain that went unrecognized at the time of liquidation.

Under the above rules for determining basis, a shareholder may receive an asset that has substantially increased in value with no immediate recognition of gain; however, if he had a low basis in the stock of the corporation, he would, subject to adjustments, have a very low basis in the assets received. Consequently, upon sale of that particular asset, he would recognize a gain because of his low recoverable basis.

The Government has continued its assertion that the shareholders of Bliss Dairy, Inc., received a "stepped-up" basis in the assets that they received as a result of the liquidation of the corporation and, therefore, the shareholders are entitled to duplicate the corporate deduction. A concise reading of Section 334 and the regulations promulgated thereon, however, clearly reflects that the shareholders did not received a "stepped-up" basis, but rather their basis in the assets was the same as their basis in the stock of the corporation, adjusted by the liabilities of the corporation they assumed. See Treas. Reg. Section 1.334-2 (26 C.F.R.) In

essence, they were not writing-off the actual cost of an asset that had already been written off by the corporation, but they are allowed to write off an amount equal to their bases in the stock of the corporation and the liabilities of the corporation that they assumed, inasmuch as such items are utilized in determining their basis in the assets that they received from the corporation. Two simple examples may be utilized to show that the shareholders did not receive a "stepped-up" basis.

Assuming that a corporation is capitalized with $1,000.00, which would be the basis that the shareholders had in the stock of that corporation. Assuming further that subsequently the corporation acquires no physical assets, such as machinery or land, but rather leases such assets on a short term basis. The corporation then recognizes a gain after taxes of $50,000.00. The corporation then purchases cattle feed for $50,000.00, with its only asset now being the cattle feed, which it has expensed. If the corporation were to liquidate, the cattle feed having a fair market value of $50,000.00 would be distributed to the shareholders, but there basis in the cattle feed would now only be $1,000.00, that

being their bases they had in the stock of the corporation. If they were to expense the cattle feed, their expense deduction would be in the amount of $1,000.00. If they were to sell the cattle feed, their taxable gain would be $49,000.00, that being the difference between the amount that they received from the cattle feed and their bases in the asset.

Assuming, on the other hand, that the corporation had no assets nor profits, but that it purchased the cattle feed on account, thus assuming a liability of $50,000.00. If the corporation were liquidated, the shareholders would not only receive the assets of the corporation, but they would also assume the liabilities of the corporation. Their basis in the asset would now be $51,000.00, that being the amount of the liabilities they assumed plus their basis in the stock of the corporation. If they were to expense the asset, they would have a deduction of $51,000.00. Additionally, if they were to sell the asset, they would not recognize gain inasmuch as their basis exceeds the fair market value. It must, however, be recognized that the shareholders do have a $50,000.00 obligation which must be paid.

Under both examples set forth above, it is clear that a double deduction is not present. In the first example, the shareholders' deduction is limited to the basis that they have in the stock or, upon sale, they would have substantial gain because of their low basis. In the second example, while they do have a substantial deduction available or no gain upon sale, they had a liability foist upon them, which they must now pay.

The idea of a "stepped-up" basis is usually used in the tax law when the basis of an asset is determined by the fair market value of an asset or its purchase price. It is used when referring to the basis of property that is received from an estate. The estate tax is applied to the fair market value of the property, regardless of the basis that the decedent had in the property. The recipients of the property are then allowed to "step-up" their basis in the property to the fair market value of the property, the value at which it was taxed. This avoids double taxation in the event that the recipients should then sell the property. See Code Section 1014.

Additionally, the term "stepped-up" basis is utilized when referring to a liquidation of a subsidiary company wherein the parent company purchased the stock of the subsidiary. The courts, under Kimball-Diamond Milling Co. v. Commissioner, 187 F.2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951), which has now been codified as Section 334(b)(2), recognized that the parent company was actually purchasing assets of the subsidiary corporation and, therefore, the basis of the assets is "stepped-up" to equal the purchase price paid for the stock. Also, the term is used to determine the basis of assets received pursuant to a liquidation under Section 331. Generally, taxpayers that receive assets from a corporation involving such a liquidation are required to recognize the gain based on the difference between their basis in the stock and the fair market value of the assets received. Therefore, if immediately after the liquidation, the shareholders were to sell the assets they received, they would recognize no gain inasmuch as their basis has been "stepped-up" to the fair market value of the asset.

The utilization of the term "stepped-up" basis is not applicable in the case before this Court inasmuch as the basis of the assets is the same as the basis that the shareholders have in the stock of the corporation, with certain adjustments mandated by the Code and the regulations promulgated thereunder. As discussed above, the interplay of Sections 333, 334 and 336 shows that while a shareholder may receive a rather highly appreciated asset following the liquidation of a corporation without recognizing any gain, that gain is eventually recognized upon the disposition of the asset by the shareholder. If, on the other hand, the asset received was the type that could be written off by the recipients, the amount available to be written off is necessarily limited.

In the present case, Bliss Dairy, Inc., received only its stock in return for the distributed property, with the value of the stock upon its succession of business and distribution of property obviously being nill. The corporation did not sell the inventory nor was there a refund or credit of amounts paid for the cattle feed. Additionally, the shareholders did not receive a

"stepped-up" basis in the assets they received, as the Government contends, inasmuch as the basis of the assets in their hands is the same as the basis that they had in the stock of the corporation, as adjusted.

It should be noted, at this point, that the application of Code Section 334(c), the method used to determine the basis of the assets that the shareholders received as a result of this liquidation, may pose even more of a hardship than the application of Code Section 334(b)(2) which was present in the cases of Commissioner v. South Lake Farms, Inc., 324 F.2d 837 (9th Cir. 1963) and Tennessee-Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440 (1975), aff'd, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979). The liquidation involved in the immediately mentioned cases involves a liquidation pursuant to Code Section 332 and 334(b)(2) wherein the basis in the assets received is determined by the basis that the parent corporation had in the stock that was redeemed, rather than the basis that the liquidated corporation had in the assets. There is a possibility that the difference between the amount paid for the stock and the basis that the subsidiary had in

the assets was gain that had gone unrecognized. Such, however, is not present in this case inasmuch as such an adjustment was not involved.

Further, a study of Code Sections 333, 334 and 336 wherein the corporation is distributing its assets to the shareholders corresponds, in principal, to a Code Section 351 transaction, where individuals contribute assets in the formation of the corporate entity. With certain statutory exceptions, there is no gain to the corporation on the contribution of appreciated assets to the corporation by the individuals. The corporation does, however, receive the assets with the same basis that the shareholder had in such assets. Consequently, if the corporation were to immediately sell the assets contributed for their fair market value, the corporation could quite possibly recognize a gain inasmuch as its basis is the same as that of the contributing shareholder.

With respect to the shareholders, they are allowed to contribute substantially appreciated property to the corporation in exchange for stock having a value equal to the fair market value of the appreciated property without recognizing a gain on the difference

between their bases in the property and the appreciated value. The shareholders' bases in the stock of the corporation, however, no matter what the fair market value of the stock may be, is equal to the bases that they had in the assets contributed. Consequently, upon sale of the stock by the shareholders, gain would be determined upon the difference between the amount received from the sale of the stock (the fair market value) and the bases that they had in the stock, that being the bases that they had in the property contributed.

The principal set forth above is the same in the liquidation at hand. The liquidating corporation is able to distribute assets that may have appreciated in value to its shareholders in exchange for the stock that they hold in the corporation with the shareholders not having to recognize gain on the difference between the value of the appeciated property and the bases that they have in the stock exchange. The stockholders will, as explained above, have their bases in the assets distributed determined with respect to their bases in the stock exchange. Therefore, if the assets have appreciated substantially, gain will be recognized even if the assets

are sold immediately because of the low bases in the assets.

The Government attempts to show that there was a recovery as a result of the liquidation of Bliss Dairy, Inc., by comparing a liquidation held pursuant to the provisions of Code Sections 333 and 336 with cases that involve liquidations involving Code Section 337. Any reliance on authorities in applying the tax benefit rule to liquidations involving Code Section 337 is misplaced inasmuch as transactions are uniquely different than corporate liquidations held under Sections 333 and 336. Under Section 337, there is no gain or loss on sales or exchanges of corporate property that occur within a twelve month period following the adoption of a complete liquidation provided the corporation distributes all of its assets within the twelve month period in complete liquidation. The question in the cases involving liquidations pursuant to Section 337, is the application of the tax benefit rule to the recovery of items which have previously been expensed, but which were sold after a plan of liquidation was adopted but not at the point of liquidation. In the Anders and Spitalny, discussed above,

it can be argued that there is a present economic recovery by the corporation in both instances inasmuch as the corporations received cash for items previously expended, but prior to the distributions to the shareholders. Following the sale of such items, the assets, including any cash, were distributed to the shareholders. It must also be noted, as discussed above, that under this type of liquidation, the shareholders recognized immediate gain on the difference between the fair market value of the assets distributed and their basis in the stock. Additionally, the assets in the hands of the shareholders now have a bases equal to the fair market value and if the assets were disposed of immediately, the shareholders would recognize no gain on the disposition.

In reviewing both types of liquidations and the subsequent effects of the shareholders, it is clear that many distinctions can be drawn, with the obvious distinction that under a liquidation pursuant to Sections 333 and 336, there is no recovery by the liquidated corporation.

The Government also seeks reliance upon the case of Tennessee-Carolina Transportation, Inc. v. Com-

missioner, 65 T.C. 440 (1975) aff'd, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979) in asserting that there must be parity between the various types of liquidations. Tennessee-Carolina case involved the application of the tax benefit rule pursuant to a liquidation under Sections 332 and 336, with the basis of the assets being determined under Section 334(b)(2). While this type of liquidation varies slightly from the liquidation involved in the present case, it is again impossible to determine that the corporation experienced a recovery. The Sixth Circuit rejected the taxpayer's contention that the tax benefit rule does not apply inasmuch as the court felt that such contentions would produce an unnecessary disparity between liquidations governed by Code Section 336 and those governed by Code Section 337. In support of its position, the Sixth Circuit Court stated that Section 336 liquidations are to be treated like Section 337 liquidations as a general rule, unless some particular provision of Section 337 justifies disparate treatment". Tennessee-Carolina, supra, page 381. That court cited Midland-Ross v. United States, 485 F.2d 110 (6th Cir. 1973), as authority for such a

general rule, with the opinion in Midland-Ross being written by the same judge that wrote the opinion in Tennessee-Carolina. There is, however, a definite distinction in the various types of liquidations. In the tax court decision, Judge Tannenwald took the opportunity to compare Sections 336 and 337. In Tennessee-Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440, 453, he stated:

> "As far as parity between Sections 336 and 337 is concerned, the courts have thus far refrained from embracing any absolute rule. See Commissioner v. South Lake Farms, Inc., 324 F.2d at 839; John T. Stewart III Trust, 63 T.C. at 693; Estate of David B. Munter, 63 T.C. at 677. Moreover, it has been pointed out that complete parity between these two sections can never exist because of specific limitations contained in Section 337. See Midland-Ross Corp., Tr. of Sur. Comm. Corp. v. United States, 485 F.2d 110, 117-118 (6th Cir. 1973). See also Bittker & Eustice, supra, par. 11.65. It cannot be gainsaid that Section 337 was enacted to eliminate the judicially created formalisms which made tax consequences turn on a determination whether a corporation in the process of liquidation or its shareholders made the sale of the assets. See S. Rept. No. 1622, 83d Cong., 2d Sess. 48-49 (1954); H. Rept. No. 1337, 83rd Cong., 2d Sess. 38-39 (1954). By way of contrast, Section 336 represented a legislative confirmation of the longstanding judicial doctrine that a corporation generally does not realize income from a distribution of its assets in kind to its shareholders. See S.

> Rept. No. 1622, supra at 46; H. Rept. No. 1337, supra at 37-38. Ct. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). But it does not follow from the fact that Section 337 was intended generally to relieve the liquidating corporation of taxability on any gain from the sale of its assets that Congress intended to impose a tax liability (which would not otherwise have been incurred) upon a corporation liquidating in kind under Section 336, simply because such liability would have been realized upon a sale of assets otherwise qualifying for nonrecognition under Section 337. Section 337 was designed to be a shield for taxpayers and not a sword to be used against them in applying other sections of the Code. I am not unmindful of the fact that there may be a trap for the unwary to the extent that a dichotomy develops between the two sections. But, as I see it, this inheres in the statutory and judicial structure. Compare Waltham Netoco Theatres, Inc., 49 T.C. 399 (1968), aff'd. 401 F.2d 333 (1st Cir. 1968)."

Further, as explained above, a liquidation involving Code Sections 333, 334(c) is drastically different than a liquidation involving Code Sections 331 or 337 in light of the method of determining as the basis of assets received by the shareholders pursuant to the liquidation. In the former mentioned liquidation, the basis is determined based on the carry over of the basis that the shareholders had in stock of the corporation where as in the latter mentioned liquidation, basis is determined at fair market value of the assets received.

In Tennessee-Carolinia, supra, 582 F.2d at p. 382, the Court recognized the holding from South Lake Farms and summarily rejected that holding in footnote 13 of its opinion. Apparently, the Court based its rejection on the premise that "recovery" of some tangible asset or sum in order to apply the tax benefit rule is not necessary. The dissent in the Sixth Circuit case, however, meets this contention head-on at page 384, by stating that:

> "Neither the majority, the majority of the Tax Court, (*1) nor the Commissioner has cited a single case in which the tax benefit rule has been applied solely on the basis of the occurrence of an event which was inconsistent with a previous deduction. To the contrary, the salient feature of every case cited by them, in which the rule was applied, is the presence of an actual economic recovery by the taxpayer, either (1) by way of receipt of funds, e.g., Citizens' Acceptance Corp. v. United States, 462 F.2d 751 (29 AFTR 2d 72-1441) (3d Cir. 1972); Anders v. United States, 462 F.2d 751 (29 AFTR 2d 72-1441) (3rd Cir. 1972); Anders v. United States, 462 F.2d 1147 (30 AFTR 2d 72-5138) (Ct.Cl.), cert. denied, 409 U.S. 1064 (1972); Spitalny v. United States, 430 F.2d 195 (26 AFTR 2d 70-5351) (9th Cir. 1970); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (20 AFTR 2d 5137) (Ct.Cl. 1967); or (2) by way of a discharge of an accrued liability resulting in an increase in the taxpayer's net worth, e.g., Mayfair Minerals, Inc. v. Commissioner, 456 F.2d 622 (29 AFTR 2d 72-706) (5th Cir. 1972); Bear Mfg. Co. v.

United States, 430 F.2d 152 (26 AFTR 2d 70-5315) (7th Cir. 1970), cert. denied, 400 U.S. 1021 (1971); North Am. Coal Corp. v. Commissioner, 87 F.2d 325 (21 AFTR 382) (6th Cir. 1938). Furthermore, the regulations under the statutory tax benefit rule, 26 U.S.C. subsection 111, require that there be an actual recovery of the prior tax benefit. Treas. Reg. subsection 1.111-1. (*1) In the Tax Court, only one Judge filed a concurring opinon and seven Judges dissented.

The majority in Tennessee-Carolina also seemed concerned with the possibility of a double deduction being available to a corporation utilizing a liquidation under Section 334(b)(2).

Judge Tannenwald, however, at page 452 in the lower court states that:

> since the petitioner realized nothing upon its own liquidation, it cannot be said to have enjoyed any "double deductions." Compare Bishop v. United States, supra, where, absent the tax benefit rule, a corporation would have twice enjoyed tax benefits where it had realized, but had not recognized, gain from Section 337 liquidation sales of inventory and where the cost of the items sold had been deducted from income in previous years under the farm-price inventory method of accounting. See also, United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969); Winer v. Commissioner, 371 F.2d 684, 686 (1st Cir. 1967).
>
> To the extent that there is a double deduction herein, it arises from the fact that the distributee corporation appears entitled to expense its "stepped-up" basis in the tires

> and tubes. But any advantage to the distributee corporation by reason of a Section 334(b)(2) "stepped-up" basis cannot be charged to the distributor-liquidating corporation. The provisions of Section 334(b)(2) merely prescribe the basis of property in the distributee's hands; that they treat the parent as though it has purchased the assets of the subsidiary does not mean that they alter the tax consequences of a liquidation pursuant to other statutory sections, e.g., by imputing a sale of the property to the liquidated corporation. See Supreme Investment Corp. v. United States, 468 F.2d 370 (5th Cir. 1972); Bijou Park Properties, Inc., 47 T.C. 207, 214 (1966); see also Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 11.44 (3d ed. 1975) (automatic operation of Sec. 334(b)(2)). The tax benefit rule does not require one taxpayer to assume a tax liability for benefits accruing to another taxpayer. Commissioner v. South Lake Farms, Inc., supra. Cf. Peter Pan Seafoods, Inc. v. United States, 417 F.2d 670 (9th Cir. 1969).

The respondent Bliss Dairy, Inc., submits that the decision rendered in South Lake Farms, supra, is the proper determination of the non-application of the tax benefit rule to a liquidation involving Code Section 336. The taxpayer-corporation in that case had deducted expenses attributable to raising crops. Prior to the harvesting of the crops, the stock of the taxpayer-corporation was sold to another corporation and the taxpayer-corporation was liquidated by the purchaser.

Pursuant to the provisions of Code Sections 332 and 336, the assets received by the acquiring corporation, the shareholder, received a basis determined pursuant to the provisions of Code Section 334(b)(2). The United States Court of Appeals for the Ninth Circuit held that since the liquidating corporation itself received nothing in the transaction, there was no recovery and, therefore, the tax benefit rule could not be applied. For the tax benefit rule to apply, there must be a recovery for the amounts previously deducted. Furthermore, the Court recognized that Congress had the authority to change the law to require the result sought by the Commissioner when it stated:

> It may be that if Congress had considered the problem now before us ... it would have inserted language desired to reach ... the results here sought by the Commissioner. But it did not do so .... If the result here is undesirable, the remedy is for Congress (and) not the Courts. 324 F.2d 840.

It must be noted that the Ninth Circuit in the case of Home Savings & Loan Association v. United States, 514 F.2d 1199 (9th Cir. 1975), specifically noted that nothing in the opinion rendered in Home Savings "is

intended, however, to impair the authority of Southlake Farms". 514 F.2d 1201 n. 1.

The Government has cited the case of Univert v. Commissioner, 656 F.2d 483 (9th Cir. 1981), cert. denied, No. 81-1467 (May 2, 1982) as an indication that the Ninth Circuit was, apparently, not concerned with the "recovery" aspect of the tax benefit rule. The concise reading of the case, however, indicates to the contrary. The case involved the actual recovery of an interest expense in 1972 that was deducted by the taxpayer in 1969. In 1969, the taxpayer erroneously deducted the interest as a current deduction rather than capitalizing the amount. One of his arguments before the Court was that the recovery of a previous expenditure is taxable as income depends upon the characterization of the deduction. Further, the taxpayer claimed that he erroneously deducted the item as an expenditure when, in fact, the expense should have been capitalized. He contended that the recovery should be treated as a return of capital because that is how the expenditure should have been treated by him on his earlier return. The Court held the taxpayer's argument unpersuasive and

reasoned that the nature of an expenditure looses its characterization as a capital expenditure and takes on the character of the deduction as claimed by the taxpayer inasmuch as the deduction was accepted. Further, the Court upheld the application of the tax benefit rule inasmuch as there was an actual recovery by the taxpayers. The statement that the Government relies upon and stated in its Opening Brief at page 44 is misplaced inasmuch as the Court was concerned with recovery but was not concerned with the "inheritant characteristic of the recovery" inasmuch as it was a recovery of an item previously expensed. The Ninth Circuit has not, therefore, deviated from the position taken in South Lake Farms.

In summary, it is clear that there was no recovery by Bliss Dairy, Inc., as a result of the liquidation. Further, it is clear that the authorities relied upon by the Government for the application of the tax benefit rule involves situations where there actually was an economic recovery. The extension of the tax benefit rule to a liquidation under Code Sections 333, 334(c) and 336 is an unwarranted extension of the tax benefit rule

for which no authority exists. An extension to the rule to this case would be to activate the abstract notion of tax benefit which was laid to rest in Hartley Associates v. Commissioner, 54 T.C. 1580 (1970).

CONCLUSION

Taking into consideration the lack of an economic recovery, coupled with the clear language of Code Section 336, it is respectively urged that the decision of the United States Court of Appeals for the Ninth Circuit should be affirmed.

Respectfully submitted,

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Petitioner's Reply Brief

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In the Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, PETITIONER

v.

BLISS DAIRY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 81-930

UNITED STATES OF AMERICA, PETITIONER

v.

BLISS DAIRY, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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1. The government's position in this case[1] rests upon a simple common sense proposition that is inherent in our system of federal taxation. If, under his accounting system, taxpayer A claims a $100 deduction in year 1, for materials to be used in his business and receives a tax benefit, and it turns out in year 2 that the materials will not be so used, he must restore the $100 to income in year 2. That is the essence of the tax benefit rule, which seeks to achieve roughly the same result that would obtain if the two events occurred in the same year. In year 1, A received a "tax benefit" of a $100 deduction. When subsequent events demonstrate that the assumptions upon which the deduction was taken were not borne out by the facts, A must restore $100 to his income. If the rule were otherwise, A could retain the benefit of a deduction for an expense that was never incurred.

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[1] We are serving a copy of this brief upon counsel for the petitioner in the companion case—*Hillsboro National Bank* v. *Commissioner*, No. 81-485.

Stripped to its essentials, the foregoing example is precisely analogous to the instant case. Here, Bliss Dairy purchased approximately $150,000 worth of cattle feed for use in its business and claimed a deduction for $150,000 on the assumption that the entire amount of feed would be consumed in its business. It turned out, however, that Bliss used only $94,000 worth of the feed in its business because it decided to terminate its business. At that time, it therefore became clear that Bliss' deduction was excessive to the extent of $56,000. It was accordingly required to restore that excessive amount to income.

The statutory rules that attend the tax consequences to Bliss and its shareholders upon the distribution of the unconsumed feed to them do not affect the application of the tax benefit rule. Indeed, the happenstance that Bliss distributed the unconsumed feed to its shareholders is not itself the critical event that triggers application of the tax benefit rule. For even if Bliss had simply put the feed to any sort of nonbusiness use, *e.g.*, if it ~~had or~~ had used the feed for its shareholders' or officers' personally-owned cattle, the result would have been the same. The significance of the shareholder distribution is that it is one type of event that shows that Bliss would not use the unconsumed feed in its business. Once it was established with certainty that Bliss was not going to devote the feed to its business uses, the $56,000 deduction became excessive and had to be restored to its income. Since that result would obtain if Bliss' feed purchase and distribution occurred in the same taxable year, the tax benefit rule operates to achieve roughly the same result where, as here, the purchase and distribution occurred in different taxable years.

2. a. Bliss Dairy's principal response (Br. 15-16, 46-52) to our position that the tax benefit rule should be applied once it became clear that $56,000 worth of feed would not be used in its business is to assert that the tax benefit rule requires an

actual recovery of money or property, and that, apart from *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979), all prior tax benefit rule cases have so held.

But in so contending, Bliss overlooks the cases we cited in our opening brief (at 22-23, 27 n.18) in which the tax benefit rule was applied despite the absence of an actual recovery.[2] As we pointed out, the decisions have recognized, virtually from the outset, that the actual recovery of money or property having a value equal to the amount previously deducted is simply one form of "inconsistent event" that calls for application of the principles that ultimately became known as the tax benefit rule. There is accordingly no basis for the attempt by Bliss and the *amicus* Ameron (Br. 20-26) to characterize the decisions of the Sixth and Seventh Circuit in *Tennessee-Carolina Transportation, Inc., supra,* and *First Trust & Savings Bank* v. *United States,* 614 F.2d 1142 (7th Cir. 1980), as relatively late and unprecedented developments in the evolution of the tax benefit rule.

More significantly, Bliss and its supporting *amici* have failed to show why the tax benefit rule should be limited to cases involving an actual recovery. As we have pointed out in our opening brief (at 21-27), the "actual recovery" that Bliss seeks to establish as the *sine qua non* of the tax benefit rule does not itself constitute "income." Instead, such an "actual recovery" triggers a tax because it is one type of

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[2]Indeed Bliss (Br. 15) erroneously cites *Home Savings & Loan Association* v. *United States,* 514 F.2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975), as an example of a case involving an actual recovery. Like the present case, *Home Savings & Loan Association* involved no physical recovery of previously deducted amounts, but rather the termination of the need for a reserve for bad debts. The court upheld the additions to the liquidated corporation's income by the amount of the overstatement of the reserves. See 514 F.2d at 1201. See also our opening brief (at 43-44 n.32).

event that establishes that a prior deduction did not ultimately reflect the taxpayer's actual loss or cost. The function of the tax benefit rule is to counterbalance the potential for income distortion that is inherent in the use of an annual accounting system. It is therefore appropriate to apply the rule whenever a subsequent event occurs that is inconsistent with the taxpayer's retention of his previously claimed tax benefits.

Very simply, whether that subsequent inconsistent event is or is not accompanied by a "recovery" is irrelevant to the purpose of the tax benefit rule: the correction of the distortion in income that would otherwise result because the premise for the deduction of an earlier accounting period has been shown to be incorrect. Neither the Ninth Circuit Court of Appeals, nor the respondent Bliss Dairy, nor the *amici* have suggested any reason why drawing the dividing line in tax benefit rule cases according to whether there has been a "recovery" has even the slightest relevance to the furtherance of any tax policy objective.

b. *Nash* v. *United States,* 398 U.S. 1 (1970), upon which Bliss relies (Br. 5, 8), does not stand for the proposition that the tax benefit rule is limited to cases involving actual recoveries of money or property. There, a partnership that had previously established a bad debt reserve transferred all of its assets (including its accounts receivable) to a newly-formed corporation for stock. As we pointed out in greater detail in our opening brief (at 27-29), the decision in that case turned on the fact that the transaction there was not an event that was inconsistent with the claim of the prior deductions because the partnership assets, including net receivables (*i.e.*, the face amount of the receivables less the reserve), were transferred for corporate stock of equivalent value. Nothing occurred in the later period to show that the earlier assumption about the collectibility of accounts receivable was wrong. As a result, there was no occasion for

the application of the tax benefit rule. Indeed, the Ninth Circuit has itself distinguished *Nash* and similar cases on this basis. See *Home Savings & Loan Association* v. *United States, supra,* 514 F.2d at 1202 ("These cases did not involve sales. They involved instances in which a continuity of ownership and business enterprise unmistakably existed.").[3]

Moreover, as the Court pointed out in *Nash* (398 U.S. at 5) there was no possibility for any "double benefit" to arise out of the partnership's transfer of the receivables to the corporation. Under the Code provision applicable to that transaction (Section 351), the corporation took a carryover basis in the partnership's assets, including the receivables less the reserves. Hence, any recovery in excess of the bad debt reserves would have been taxable income to the corporation. Here, on the other hand, if Bliss is not required to restore its excessive deduction to income, both it and its shareholders will have claimed a deduction with respect to the same feed. *Nash* is therefore distinguishable.

Bliss nevertheless suggests (Br. 3-4, 6, 32-39, 47-48) that there was no actual "double benefit" that occurred in this case. It does not deny, however, that it stipulated in the trial court (Pretrial Order, paras. III-D and III-G) that it did, in fact, deduct the full cost of the distributed feed on its

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[3]Accord: B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* para. 11.62, at 11-62 to 11-63 n.147 (4th ed. 1979) ("This case [*Nash*] may be inapplicable to liquidations, because of the stepped-up basis acquired by the transferred assets [in liquidations]").

As we pointed out in our opening brief (at 38-39), there would be no occasion for applying the tax benefit rule if Bliss had transferred the unconsumed cattle feed to a parent corporation or to a successor corporation in a qualifying tax-free reorganization in which the transferee would take a "carryover basis" of zero in the feed. Here, however, unconsumed feed took on a new basis in the hands of the shareholders under Section 334(c). The tax benefit rule is therefore fully applicable.

corporate tax return for its taxable year ending June 30, 1973, and that its shareholders, who continued to operate the business in noncorporate form, thereafter claimed further deductions "attributable to the feed they received from the liquidation on their 1973 U.S. Individual Income Tax Returns." In short, Bliss cannot deny that two deductions were enjoyed with respect to the same expense.

Here, Bliss itself plainly enjoyed a tax benefit as a result of its deduction of an outlay for materials that were not actually consumed—and which, therefore, did not actually become an "expense"—in the operation of its own business.[4] It is that benefit, we submit, that requires an adjustment under the tax benefit rule in the following year when it became clear, on the corporation's liquidation, that the feed would never be used in the ordinary course of its operations. Moreover, the shareholders remained entitled to claim a further deduction when the feed ultimately is consumed, whether or not such materials were previously "expensed" by the corporation.

c. Contrary to Bliss' further argument (Br. 32-33), its shareholders took a "stepped-up" basis in the unconsumed feed under Section 334(c). As we pointed out in our opening brief (at 40-41 & n.29), the shareholders' basis was increased from the "zero" basis the feed had in the hands of Bliss. Such an increase is appropriately characterized as a "stepped-up" basis even though the amount of this increased basis may not necessarily be equal to the fair market value of the feed or to the full amount of the deduction claimed by Bliss.

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[4]Contrary to the thesis of the *amicus* Ameron (Br. 7, 11-12, 16, 18-19), the "expense" is not the cash outlay for materials, but the ultimate consumption of the materials in the course of operations. See, *e.g.*, C. Niswonger & P. Fess, *Accounting Principles* 33, 214 (10th ed. 1969). See also H. Sellin, *Attorney's Handbook of Accounting* § 6.06[3] (3d ed. 1982).

The basis assigned to the distributed assets in the case of a Section 333 election is derived from the shareholders' cost of acquiring the stock at some earlier time. See Section 334(c). Thus, the deduction claimed by the shareholders for previously "expensed" materials may differ somewhat from the deduction originally claimed by the corporation.[5] But that difference does not serve to distinguish this case from *Tennessee-Carolina Transportation, Inc.* (where the "stepped-up" basis was derived, pursuant to the provisions of Section 334(b)(2), from the cost of acquiring the taxpayer-corporation's shares shortly before its liquidation), or, indeed, from a liquidation in which the feed would take a fully "stepped-up" basis equal to its fair market value under Section 334(a) of the Code. In short, such differences in the degree of the "double" benefit do not mask the essential fact that Bliss' liquidating distribution of the unconsumed feed is an event that undermines the premise on which its original deduction was claimed. That fact warrants the restoration to income of the amount that did

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[5]As we pointed out in our opening brief (at 38 n.26), the record does not show that any part of the $57,000 liquidation date value of the unconsumed feed was due to an increase in the market value of the feed between the date of Bliss' purchase and the date of the liquidation. If such were the case, the amount includable in Bliss' income under the tax benefit rule would, of course, be limited to Bliss' cost for the feed. The tax benefit rule seeks to correct prior deductions for expenses not actually incurred, it does not tax appreciation in the value of assets. Thus, even though, the shareholders' basis in the feed may be less than Bliss' cost for the feed, the tax benefit rule nevertheless requires restoration of Bliss' cost of the feed to its income to offset the prior deduction that proved to be unwarranted.

not prove to be an "expense" incurred in the conduct of Bliss' business.[6]

4. Finally, Bliss (Br. 18-25) and the *amicus* Armstrong (Br. 3-4, 5-6, 15-17, 24-27) contend that the "plain language" of Section 336 of the Code precludes the Commissioner from applying the tax benefit rule here. Section 336 provides (with an exception not here relevant) that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." But this language is virtually identical to that used in the parallel provisions of Section 337 of the Code.[7] As we pointed out in our opening brief (at 42 n.31, 48-50), the courts have rejected similar contentions under Section 337. They have uniformly held that Section 337 poses no barrier to the application of the tax benefit rule in the case of "expensed" assets

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[6]Bliss cites an example (Br. 33-34) of a Section 333 liquidation in which the aggregate basis in the shares of the liquidating corporation's stock is only a fraction of the value of the assets the shareholders receive, and in which the distributed assets consist entirely of previously expensed materials. While such an extreme case is conceivable, there is no suggestion on the record here that it remotely resembles the facts before the Court. At all events, there would still be a "double" deduction in such a case to the extent of the basis that is attributed to the feed.

More significantly, however, permitting Bliss to retain the deduction it claimed for the unconsumed cattle feed allows that corporation to retain an unwarranted offset against its earnings and profits. Under Section 333(e), a noncorporate shareholder receiving a liquidating distribution under Section 333 must recognize as a dividend so much of his gain that is equal to his ratable share of the corporation's earnings and profits. Thus, unless the tax benefit rule is applied, the shareholders in Bliss' hypothetical case, as here, would obtain a further benefit to the extent that they would themselves avoid being taxed under Section 333(e) on that portion of their gain (virtually all of it) that represents the corporation's actual earnings and profits. Thus, Bliss' example likewise illustrates the justification for the tax benefit rule.

[7]Section 337(a) provides generally that if a corporation adopts a plan of liquidation and then liquidates within the following 12-month period, "no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

that are sold pursuant to a plan of liquidation under Section 337. As these courts concluded, the word "gain" as used in these provisions is a term of art, referring to the profit derived from the disposition of an appreciated asset. See *Commissioner* v. *Anders*, 414 F.2d 1283, 1288 (10th Cir.), cert. denied, 396 U.S. 958 (1969); *West Seattle National Bank* v. *Commissioner*, 288 F.2d 47, 49-50 (9th Cir. 1961); *Estate of Munter* v. *Commissioner*, 63 T.C. 663, 674 (1975).[8] And as the court of appeals in *Tennessee-Carolina Transportation, Inc.* pointed out, "[t]here is no reason in either the statute or tax policy for reaching a different result in this case merely because * * * taxpayer chose a § 336 liquidation" instead of Section 337 (582 F.2d at 381).

By contrast, the amount which the Commissioner seeks to include in Bliss' income in the present case does not result from the disposition of an appreciated asset. Rather, that income is the ordinary business income of Bliss' prior taxable period that had gone untaxed as a result of the offset

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[8]We believe, however, that *Putoma Corp.* v. *Commissioner*, 601 F.2d 734 (5th Cir. 1979), upon which *amicus* Ameron relies (Br. 26-27) was incorrectly decided. There, the taxpayer corporation had accrued and deducted interest it owed but never paid one of its shareholders. In a divided decision, the court held that the corporation did not realize taxable income when the shareholder cancelled the liability for accrued interest because the amount was a nontaxable contribution to capital. But as the dissent properly pointed out (601 F.2d at 751-754), the only portion that can be characterized as a contribution to capital is the principal portion of the debt, not the accrued interest. The restoration of the interest deduction to the taxpayer's income is necessary to offset the tax benefit of the deduction for a payment it did not make and never would make. Indeed, one could well conclude that the decision makes sense only if the cancelled interest is included in the income of the shareholder. See O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 Tax L. Rev. 215, 241, 243 (1972); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 50 Notre Dame Law. 215, 245-246 (1980). At all events, the capital contribution rationale of *Putoma Corp.* is wholly inapplicable to the instant case.

provided by Bliss' cattle feed deduction—a deduction that was based on an anticipated "expense" that Bliss in fact never incurred. See page 6, note 2, *supra*. As the Ninth Circuit stated in *West Seattle National Bank, supra,* 288 F.2d at 49 (emphasis added), in applying the tax benefit rule to a sale (pursuant to a plan of liquidation) of accounts receivable at face value, notwithstanding the "no gain or loss" language of Section 337:

> If [an increment] is to be held a gain, it must be because it is of the character of a gain. That a bad debt recovery is not of such a character was pointed out by this court in National Bank of Commerce of Seattle v. Commissioner of Internal Revenue, 9 Cir., 1940, 115 F.2d 875. There it was said that to the extent of deductions taken, a debt loses its nature as capital and takes on the character of the untaxed income which the deduction represents. An increment realized in this area over and beyond adjusted basis *does not then represent any gain in capital or asset value. Rather, it represents income earned in the past which has escaped taxation.*

The legislative history of Section 336 indicates that the word "gain" was used there in the same sense. The language of Section 336 was derived from a 1939 Code Treasury Regulation (Treas. Reg. 118, § 39.22(a)-20). See S. Rep. No. 1622, 83d Cong., 2d Sess. 258 (1954). That section of the Regulation, insofar as here pertinent, stated as follows:

> No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, *however they may have appreciated or depreciated in value since their acquisition.* [Emphasis added.]

As the italicized language demonstrates, the term "gain" was used in its usual tax sense as a profit from the disposition of an appreciated asset, and not in some more general

sense that would preclude charging the corporation with a restoration of ordinary income under the tax benefit rule.

Moreover, Section 336 was enacted at the same time as, and was originally included in the same proposed section with, Section 311 of the Code (which generally provides for the nonrecognition of gain by a corporation making a non-liquidating distribution of property). These two sections were "designed to be parallel provisions, and * * * should be interpreted consistently." *Williamson* v. *United States*, 292 F.2d 524, 528-529 (Ct. Cl. 1961). The Senate Finance Committee's discussion of Section 311 stated that (S. Rep. No. 1622, *supra*, at 247)—

> your committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of *Commissioner* v. *First State Bank of Stratford* (168 F.2d 1004, cert. den. 335 U.S. [867]).

In *Commissioner* v. *First State Bank*, 168 F. 2d 1004, cert. denied, 335 U.S. 867 (1948), the Fifth Circuit had relied on assignment-of-income and tax benefit principles in holding that a bank must recognize income upon its distribution of notes with respect to which it had previously taken bad debt deductions. Accordingly, the Senate Report's reference to *First State Bank* demonstrates that neither Section 311 nor Section 336 was designed to override the application of general tax principles, such as the assignment-of-income doctrine and the tax benefit rule, but that those Sections were intended only to provide for the nontaxability of gain arising from the disposition of an appreciated asset by way of corporate distributions to shareholders.[9]

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[9]See *Williamson* v. *United States*, *supra* (assignment-of-income doctrine applied to corporate liquidation despite "no gain or loss" language of Section 336). See also Lyon & Eustice, *Assignment of Income: Fruit*

Accord: Feld, *The Tax Benefit of Bliss*, 62 B.U.L. Rev. 443, 451-462 (1982).

Finally, Bliss concedes (Br. 11-14) that the courts have correctly applied the tax benefit rule in the case of Section 337 pre-liquidation sales, despite the "no gain or loss" language of Section 337. Given the congressional intention underlying Section 337 to reduce the disparities between such pre-liquidation sales and in-kind liquidation distributions (see our opening brief at 48), we submit that the "no gain or loss" provisions of Section 336 should be construed in the same manner.

Bliss, however, attempts (Br. 13-14) to distinguish the Section 337 tax benefit rule cases on the ground that in each of those cases there was an actual recovery of the prior tax benefit—*i.e.*, on the ground that the "expensed" materials were converted into cash for distribution to the shareholders. But as we pointed out in our opening brief (at 42 n.31), there is no economic difference between the position

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and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 295, 414-415 (1962):

> It seems clear that the tax advantages permitted in *South Lake* [*i.e.*, *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), the case relied on here by the court below] were not envisioned when Congress in 1954 enacted the provisions of sections 334(b)(2) and 337. It may be that other judges will block such unintended benefits. As we have noted earlier, there would seem to be more than enough tax principles and provisions to support such action. And the remedy might well be adjustments in the liquidating corporation's final year that would disallow expenses of such year and, in addition, add to income of such year an amount equal to expenses deducted with tax benefit in prior years, thus following much the same approach the courts have used where a corporation distributes notes which it has previously written off as worthless.[460]

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[460] As in *Commissioner* v. *First State Bank*, 168 F.2d 1004 (5th Cir. 1948). • • •

of a corporation that sells "expensed" property and distributes the proceeds to its shareholders, and a corporation that retrieves such fully "expensed" property for in-kind distribution so that its shareholders may sell or use such valuable materials as they see fit.[10] Compare *Spitalny* v. *United States*, 430 F.2d 195, 198 (9th Cir. 1970), with *Tennessee-Carolina Transportation, Inc., supra*, 582 F.2d at 381. Nor is there any basis in the statutory language of Sections 336 and 337 for drawing a distinction between cases involving an "actual recovery" of cash and those involving simply the "recovery" of the expensed materials themselves. Accordingly, the cases applying the tax benefit rule to Section 337 pre-liquidation sales are also persuasive authority for applying it to in-kind distributions under Section 336.[11]

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[10]Indeed, the "recovery" of such expensed materials represents just as much an increase in the net worth of the corporation as does, for example, the discharge of accrued "liabilities" that are unclaimed or turn out not to be owing (*e.g., Mayfair Minerals, Inc.* v. *Commissioner*, 456 F.2d 622 (5th Cir. 1972); *Bear Manufacturing Co.* v. *United States*, 430 F.2d 152 (7th Cir. 1970), cert. denied, 400 U.S. 1021 (1971); *G.M. Standifer Construction Corp.* v. *Commissioner*, 30 B.T.A. 184, 186 (1934), appeal dismissed, 78 F.2d 285 (9th Cir. 1935)), or the release of a previously established reserve for bad debts (*e.g., Home Savings & Loan Association* v. *United States, supra*). In each case, what was previously "written off" becomes available for purposes other than those for which the original deduction was claimed. Thus, there is no valid distinction based upon the nature of the "recovery" in such cases.

[11]Bliss also contends (Br. 16-17) that application of the tax benefit rule here is precluded by the statement in Section 1.111-1(a)(2) of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) that "[r]ecoveries" result from the "receipt" of amounts in respect of previously deducted bad debts or taxes. Thus, Bliss argues the Regulation's use of the word "receipt" is intended to limit the application of the tax benefit rule to cases where there is an actual recovery.

But the Regulation's definition of "recovery" must be read in light of Section 111 and its underlying purpose. Section 111, as its terms indicate, was enacted simply to make it clear that the prior deduction on

CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

REX E. LEE
Solicitor General

OCTOBER 1982

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which the tax benefit rule's application is being based must have given rise to an actual tax benefit in order for the rule to be applied, and that a deduction which did not result in a tax savings would not suffice. See H.R. Rep. No. 2333, 77th Cong., 2d Sess. 45 (1942). It does not, by its terms, govern the inclusionary aspect of the rule, nor does it expressly encompass all circumstances in which the exclusionary aspect applies. Yet, as the courts have held, it implicitly approves the previously established inclusionary principles, modifying them only to the extent that it resolved the then-remaining dispute as to whether the amount to be restored to income should be limited to the amount of the prior deduction that led to an actual tax benefit. See, *e.g.*, *Continental Illinois National Bank & Trust Co.* v. *Commissioner*, 69 T.C. 357, 370 (1977). Thus, the Regulation's definition of "recovery" has a limited function, and does not have any significance for this case where it is undisputed that the taxpayer's prior deduction gave rise to an actual tax benefit.

DOJ-1982-10

Amicus Brief

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IN THE

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October Term, 1981

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Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF OF AMICUS CURIAE, AMERON, INC., IN SUPPORT OF RESPONDENT, BLISS DAIRY, INC.

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Petitioner,

vs.

BLISS DAIRY, INC.,

Respondent.

BRIEF OF AMICUS CURIAE, AMERON, INC., IN SUPPORT OF RESPONDENT, BLISS DAIRY, INC.

Interest of Amicus Curiae.

Pursuant to Rule 36.2 of the Rules of this Court, and with the consent of the parties, this Brief of *Amicus Curiae* is filed on behalf of Ameron, Inc., a California corporation, in support of respondent, Bliss Dairy, Inc. Ameron has a significant interest in the case at bench by reason of the following circumstances.

Ameron is the appellant in a case now pending in the United States Court of Appeals for the Ninth Circuit, *Ameron, Inc. v. United States of America*, 81-5398, involving the tax benefit rule. The matter is on appeal from a judgment in favor of the Government, rendered by the United States District Court for the Central District of California. On June 7, 1982, following oral argument before the Court of Appeals, the court entered an order deferring

submission of the appeal pending the decision by this Court in *Bliss Dairy, Inc. v. United States of America*. Such deferral was urged by the Government in its brief to the Ninth Circuit, and again during oral argument, expressly in recognition of the fact that one of the Government's principal arguments in that case, that an actual recovery is not a prerequisite to the application of the tax benefit rule, was contrary to the Ninth Circuit's *Bliss Dairy* decision.

It is apparent, therefore, that this Court's decision and rationale in *Bliss Dairy* and the other case pending with it, *Hillsboro National Bank v. Commissioner of Internal Revenue*, 81-485, could vitally affect the outcome of Ameron's appeal. Accordingly, we believe this Court should be made aware of the circumstances involving the Government's effort to apply the tax benefit rule in *Ameron*, because the facts of that case are materially different from either *Bliss Dairy* or *Hillsboro*. Indeed, we believe *Ameron* represents by far the most extreme extension yet of the "inconsistent event" theory which the Government seeks to have approved by this Court.

The *Ameron* case arose out of certain amendments to a qualified pension plan maintained by a subsidiary of Ameron for the exclusive benefit of the subsidiary's employees. The issue is whether the tax benefit rule justifies requiring the employer to include in its own income for the year of amendment some $700,000 it previously had contributed to the plan even though the employer did not receive or have a right to receive any of the money. The plan was funded by an annuity contract between the employer and an insurance company which required the insurance company to pay annuities to employees when they retired. Because the plan at all times was "qualified" under §§ 401 *et seq.* of the Internal Revenue Code, the employer was

allowed to deduct its contributions to the plan made in the form of premiums paid to the insurance company.

Prior to the amendments in question, the plan covered both salaried and hourly employees. The amendments were required because the hourly employees elected to voluntarily withdraw from the plan in order to join their union's pension plan. The withdrawal and resulting forfeiture of their annuity rights created "surrender credits" amounting to approximately $700,000, which represented premiums the employer previously had paid to the insurance company for the forefeited annuities.[1] Under the amendments to the plan, the insurance company agreed to apply the surrender credits toward the purchase of retirement annuities for all of the salaried employees who still were covered by the employer's plan. The funds in fact remained with the insurance company and are being used by it solely for that purpose.

The Government contends in *Ameron* that the "inconsistent event" rationale of the tax benefit rule justifies taxing the employer on the $700,000 surrender credits. The Government argues that the funds represented deductions made for the benefit of the hourly employees who withdrew from the plan, and the reallocation of the benefits to a different group of employees is "inconsistent" with the reason for the original deduction. The Government argues that it is irrelevant that the employer had no right to receive the surrender credit, before or after the amendments. It is likewise deemed to be irrelevant that the plan remained "qualified" after the amendments, so that the use of the funds

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[1]While the withdrawing union employees forfeited their annuity rights under the employer's pension plan, they did not actually lose anything. The Teamsters' Union plan which they joined provided for full past service credits. Of course, the employer's contribution rate for the union plan was set at a level sufficient to pay for those past service credits as well as future service credits.

for the salaried employees' retirement annuities was a proper, deductible purpose.[2]

We believe that *Ameron* is distinguishable from the facts in either of the two cases pending before this Court, and that our situation clearly does not fit the rationale for the Government's interpretation of the tax benefit rule as expressed in its brief to this Court. But the very existence of our case proves that the Government is not limiting its attempted use of the "inconsistent event" theory to cases which fit that rationale. Furthermore, as we will demonstrate *infra*, the Government's interpretation is far too broad and is not justified by the governing Treasury Regulations or sound judicial precedent.

Summary of Argument.

The tax benefit rule generally is understood to provide that the return or recovery of money or property which was the subject of an income tax deduction in a previous year must be treated as income in the year of recovery to the extent that the taxpayer derived a tax benefit from the earlier deduction. *Alice Phelan Sullivan Corporation v. United States*, 381 F.2d 399, 401-402 (Ct. Cl. 1967). The partial codification of this judicially created rule, Section 111 of the Internal Revenue Code, and the Treasury Regulations which broaden the statutory coverage, plainly require such a recovery to trigger the operation of the rule.

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[2]Indeed, the taxpayer contends that the reallocation of the surrender credits to other employees covered by the plan, by applying the funds to the purchase of retirement annuities for them before any further employer contributions to the plan could be deducted, was precisely what the law governing such plans mandated in order that the plan retain its qualified status. See Internal Revenue Code Section 404(a)(2); Reg. Section 1.404(a)-8(a)(3); Revenue Ruling 65-178, 1965-2 C.B. 110-111; Revenue Ruling 68-242, 1968-1 C.B. 156. Again, the Government does not dispute this contention, but argues that it is irrelevant for purposes of the tax benefit rule.

Notwithstanding the language of the statute and regulations, the Government contends the rule is not limited to cases where the taxpayer actually or even constructively recovers the previously deducted sum or its economic equivalent. The Government argues that "the rule also requires a restoration to income of a previously deducted expense when subsequent events eliminate the factual premise on which the deduction was originally claimed." (Govt's. Br. p. 18.) Hence, the taxpayer need not receive or have a right to receive anything of value to be taxed on a prior deduction. In the Government's view, "the triggering event can be any after-arising circumstance that demonstrates the invalidity of the factual premise on which the prior deduction was originally claimed. It is this so-called 'inconsistent event' that lies at the heart of the tax benefit rule and requires a corrective adjustment to set matters right." (Govt's. Br. p. 20.)

Thus, as the Government interprets the rule, it has the power to disallow, *ex post facto*, a previously claimed deduction which was entirely proper at the time it was claimed, anytime a subsequent event occurs which the Government considers to be "inconsistent" with the "factual premises" on which the deduction was claimed. Such a rule, we submit, would be entirely too broad and would provide no guidance to courts, taxpayers or the Government as to what is or is not an "inconsistent event."

Furthermore, the Government's broad interpretation is not supported by sound judicial authority. The Government weaves its theory out of *dicta*, isolated statements taken completely out of context, and a general misconstruction of the real purpose and justification for the tax benefit rule.

Upon proper analysis, it will be seen that the tax benefit rule as it was judicially interpreted and actually applied prior to the Sixth Circuit Court of Appeals' decision in *Tennessee-*

Carolina Transportation, Inc. v. Commissioner, 582 F.2d 378 (6th Cir. 1978), cert. den., 440 U.S. 909 (1979), is consistent with the position urged by this *amicus* and by the taxpayers in *Bliss Dairy* and *Hillsboro*. Although some of those pre-*Tennessee-Carolina* cases repeated the "inconsistent event" *dictum* which originated with the case of *Estate of William H. Block*, 39 B.T.A. 338, 341 (1939), the holdings and actual facts of all of the cases establish the following fundamental principles:

(1) Where a prior deduction is based upon an *actual disbursement* of funds by the taxpayer, the tax benefit rule is triggered *only* by an actual recovery thereof — that is, by a receipt of money or property or its economic equivalent as a refund or other compensation or reimbursement for what previously was paid out and deducted. (2) Where the previous deduction is based upon a claimed loss, such as on a debt believed to be worthless, the tax benefit rule is applicable only if the taxpayer later *collects* the debt or otherwise receives economic compensation for the loss which was claimed. (3) Where the previous deduction is based upon the *accrual* of an expense or liability, but the taxpayer actually has not paid out the amount for which the deduction was claimed, the cancellation or reduction of the expense or liability results in income under the tax benefit rule. In this instance alone, the rule applies without any receipt of money or property. But even in these cases, the courts have recognized that there is the economic equivalent of a "recovery" in that the cancellation or reduction of the accrued expense or liability relieves the taxpayer of having to actually pay it, thereby increasing his net worth.

The Government seeks to justify extending the rule to situations in category number (1) even though the amount paid out has never been recovered by the taxpayer. This is done by pointing to language from cases in categories (2)

and (3) to the effect that the rule requires the taxpayer to restore to income the amount of the deduction claimed when the loss or expense was not actually incurred. But this ignores the reason why it was not actually incurred in those situations — in category (2) because there was a collection, and in category (3) because the liability did not have to be paid, freeing the taxpayer's assets for other uses.

It is nonsense to suggest, as the Government does, that an "expense" which is disbursed and never recovered nevertheless is "not actually incurred" because in a later year an event occurs which arguably would have made the item non-deductible if it had happened in the year of the deduction. The cases prior to *Tennessee-Carolina* certainly do not justify such an absurd result.

As for *Tennessee-Carolina*, and the cases which have followed its holding, *First Trust & Savings Bank v. United States*, 614 F.2d 1142 (7th Cir. 1980) and *Hillsboro National Bank v. Commissioner*, 641 F.2d 529 (7th Cir. 1981), we respectfully submit that they are incorrectly reasoned and should be rejected. They effected a change in the law which was not justified by the authorities they relied upon.

ARGUMENT.

I.

The Tax Benefit Rule Expressed in Internal Revenue Code Section 111 and the Regulations Requires a "Recovery."

The tax benefit rule, initially a judicially created concept, has received congressional approval through partial codification. The present statutory expression of the rule is found in Section 111 of the Internal Revenue Code. The statute is phrased in exclusionary terms, providing that gross income does not include income attributable to "the recovery during the taxable year" of previously deducted bad debts, taxes or delinquency amounts, to the extent of the "recovery exclusion" defined in the statute and regulations. The "recovery exclusion" excludes the recovered item from income to the extent the taxpayer did not derive a tax benefit from the prior deduction. The treasury regulations broadened the statutory rule of exclusion by extending similar treatment to "recovery" of all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years, except for deductions with respect to depreciation, depletion, amortization and amortizable bond premiums. Reg. § 1.111-1(a).[3]

The term "recovery" is defined in the regulation as follows:

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[3]In *Alice Phelan Sullivan Corporation v. United States*, 381 F.2d 399, 402 (Ct. Cl. 1967), one of the most frequently cited decisions expressing the tax benefit rule, the court held as follows: "Drawing our attention to the broad language of this regulation, the Government insists that the present recovery [an actual receipt of property previously donated to charity] must find its place within the scope of the regulation and, as such, should be taxed in a manner consistent with the treatment provided for like items of recovery, *i.e.*, that it be taxed at the rate prevailing in the year of recovery. We are compelled to agree."

> "(2) Definition of 'recovery.' Recoveries result from the *receipt* of amounts in respect of the previously deducted or credited section 111 items, such as from the *collection or sale* of a bad debt, *refund or credit* of taxes paid, *or cancellation* of taxes accrued. . . ." (Emphasis added) Reg. § 1.111-1(a)(2).

It is abundantly clear from the language of both the statute and the regulation that an actual receipt by the taxpayer of money or property or the economic equivalent thereof is not only contemplated, but constitutes the *sine qua non* for the rule. Without such a "recovery," there is no need to determine the amount, if any, of the "recovery exclusion." Nothing contained in the statute or regulation, or their predecessors, even suggests that the tax benefit rule might apply in the absence of a recovery merely because some other event occurred which is alleged to be inconsistent with a prior deduction.

In its brief to this Court, the Government attempts to demonstrate that an actual receipt of the deducted item is not the critical element necessary to support the application of the tax benefit rule by discussing a hypothetical state income tax refund. (Govt's. Br. pp. 18-21.) The Government points out, correctly, that the tax benefit rule would apply to a refund of previously deducted state income taxes regardless of whether the refund was actually paid to the taxpayer or simply credited by the state against the taxpayer's income tax liability for the next year. *But such result is expressly covered by Internal Revenue Code section 111 and the above quoted regulation.* That is, the rule applies to "a refund or credit of taxes paid, or cancellation of taxes accrued." Reg. § 1.111-(a)(2). This is entirely consistent with the position of this *amicus* that the tax benefit rule is not triggered with respect to previous deductions based on actual payments of money by the taxpayer unless the tax-

payer recovers that money or its economic equivalent. A credit against future taxes is, of course, the economic equivalent of a cash refund.[4]

Certainly, the statutory application of the tax benefit rule to tax refunds which are credited rather than paid to the taxpayer does not in any way justify the Government's conclusion that "actual receipt or recovery of the money or property disbursed in connection with the prior year's deduction is not a requirement of the tax benefit rule." (Govt's. Br. p. 20.)

II.

The Holdings of the "Early Cases" Relied Upon by the Government Do Not Support Its Contention That the Rule May Be Applied, Without Any Recovery, Based Solely on an "Inconsistent Event."

Ignoring the plain language of the Commissioner's own regulation, the Government relies on several "early cases" in support of its "no recovery" thesis. (Govt's. Br. pp. 8-10, 21-24.) These early decisions by the Board of Tax Appeals, along with the writings of a few "legal scholars and commentators" (Govt's. Br. p. 24, n. 16), are cited for the proposition that the tax benefit rule did not turn upon the identification of economic benefits that could be considered to be actual current taxable income. Rather, they

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[4]Similarly, the cancellation of taxes which have been accrued and deducted, but not yet paid, produces an economic effect identical to a refund or credit of taxes which were previously paid. It is well settled that the cancellation or elimination of any accrued but unpaid expense or loss results in an increase in the taxpayer's net worth by the amount of the discharged liability, justifying treatment of that amount as a recovery under the tax benefit rule. See, *e.g.*, *Bear Manufacturing Co. v. United States*, 430 F.2d 152 (7th Cir. 1970), cert. den., 400 U.S. 1021 (1971); *Mayfair Minerals, Inc. v. Commissioner*, 456 F.2d 622 (5th Cir. 1972); *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378, 384 [dissent] (6th Cir. 1978).

recognize that the rule is a remedial device designed to assure that a taxpayer's income over a period encompassing several taxable years is actually reflected when subsequent events establish that no loss or expenses will be incurred. Putting it another way, the rule is said to rectify the distortion caused by the taxpayer's having taken a deduction to which, in light of hindsight, he would not be entitled, thereby preventing unjust enrichment of the taxpayer.

We have no quarrel with these general statements offered in some cases and by legal writers to help explain the tax benefit rule. We agree that the rule applies regardless of whether that which is recovered would be income or economic gain in the ordinary sense, if considered by itself. But that certainly does not mean that a recovery need not occur at all. There is income under the rule precisely and only because a previous deduction has been recovered. It is the recovery which means the taxpayer in fact did not incur the loss or expense on which the deduction was based; and it is because of that recovery that the taxpayer would be unjustly enriched if he were permitted to retain the benefit of the deduction without reporting the recovery as income.

But the Government takes the explanatory language of these early decisions completely out of context in order to advance the central premises to its thesis, that the so-called "inconsistent event" rationale is what is really "at the heart of the tax benefit rule," not the recovery of the previously deducted item; and that the triggering event can be "any after-arising circumstance that demonstrates the invalidity of the factual premise on which the prior deduction was originally claimed." (Govt's. Br. p. 20.) In so doing, the Government seeks to extend the rule to situations like that involved in Ameron's case, where a deduction was properly claimed with respect to an actual disbursement of money by the taxpayer but some later event has occurred which the

Government views as being "inconsistent" with the reason for the deduction — even though the taxpayer has not recovered the disbursed funds or their economic equivalent. In other words, the Government seeks a rule which will enable it to invalidate, *ex post facto*, a previously allowed proper deduction, converting it into a non-deductible expenditure through the device of requiring the taxpayer to restore the deduction to current income. It is submitted that careful analysis of the actual facts and holdings of the decisions cited by the Government do not justify any such rule.

The first of the early cases referred to by the Government is *South Dakota Concrete Products Co. v. Commissioner*, 26 B.T.A. 1429 (1932), which is cited by the Government and at least one writer for the "balancing entry" rationale to the tax benefit rule. (Govt's. Br. p. 22; 1 Bitker, Federal Taxation of Income, Estates and Gifts, ¶5.7.1, pp. 5-45.) There the Board of Tax Appeals held that a recovery by the taxpayer of embezzled funds which previously had been deducted required inclusion of the funds in the taxpayer's income in the year of recovery. The Board explained:

> "The Commissioner has added no more to income than has been deducted previously, thus bring the amount of income reported over the period in balance with the actual income of the taxpayer for this period. *In the year 1926 the petitioner actually received in cash, for its own use and benefit, income earned in previous years, but unlawfully taken from it. . . .* The fact is that the petitioner was entitled to the deductions so far as the amount was concerned and it received the benefit of them. It has frequently been held that when recovery is made on debts once deducted as bad, the amount recovered is properly to be reported in income for the year of recovery. (Citations omitted)" Expenses once deducted but reduced by later adjustments require

similar treatment. (Citations omitted). Furthermore, these cases hold that income-tax liability under the Federal revenue acts is to be determined on annual periods on the basis of facts as they existed in each period, *and when an adjustment occurs which is inconsistent with what has been done in the past in the determination of tax liability, the adjustment should be reflected in reporting income for the year in which it occurs*. That any other system would be so uncertain and unsatisfactory as to require its rejection is apparent if one considers the effect of the statutes of limitation, the obvious administrative difficulties involved, together with the lack of finality which would exist as to all income-tax liability. In laying down these rules the courts and this Board have been fully conscious of the fact that losses will some times be deducted *where the future will eventually disclose compensation*, and there will be reported as income *that which is in fact compensation for the loss*. But the deductions are practical necessities due to our inability to read the future, and the inclusion of the recovery in income is necessary to offset the deduction. Where, as here, a taxpayer has received the benefit through an offset against income of amounts embezzled from it, we perceive no distinction in principle from the rule laid down in the above cases. Therefore, we hold that when the taxpayer recovers the amounts previously embezzled and off set against income, it must report the amount as income for the year of recovery." (Emphasis added) *Id.* at 1431-1432.

Read in proper context, what the Board obviously meant by an "adjustment" inconsistent with what was done in the past was a "recovery" of a previously deducted item, as in the facts actually at issue, or the cancellation or other

reduction of an accrued expense.[5] Nothing contained in the opinion or in the cases it cites suggests a meaning as broad as the Government's present interpretation.

Seven years later, the Board of Tax Appeals decided *Estate of William H. Block v. Commissioner*, 39 B.T.A. 338 (1939), aff'd *sub nom., Union Trust Co. of Indianapolis v. Commissioner*, 111 F.2d 60 (7th Cir. 1940). This case is the acknowledged genesis of the so-called "inconsistent event" rationale. See, *e.g. Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378, 382, 383-384 (6th Cir. 1978); *First Trust & Savings Bank of Taylorville*, 614 F.2d 1142, 1145-1146 (7th Cir. 1980); Revenue Ruling 74-396, 1974-2 CB 106. The facts before the Board of Tax Appeals involved a refund of Federal estate taxes which had been paid in a previous year and, under the law then in existence, allowed as a deduction against the income of the estate. The Board properly held that the refund was required to be included in the estate's income in the year of recovery under the tax benefit rule. Accordingly, the holding of the case represents nothing more than a straight-forward application of the tax benefit rule to an *actual recovery*. Indeed, such situation now is *expressly covered* by the provisions of Internal Revenue Code Section 111.

Unfortunately, the Board's explanation of its holding included the now familiar *dictum* emphasized in the following quotation:

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[5]The Government also cites the case of *G.M. Standifer Construction Corp. v. Commissioner*, 30 B.T.A. 184 (1934), appeal dismissed, 78 F.2d 285 (9th Cir. 1935), as being in "accord" with the Government's present thesis. However, that case simply stands for the now undisputed proposition that deductions for accrued but unpaid liabilities must be restored to income in the year in which the liabilities are extinguished without actual payment. The Board reasoned that such situation was no different from recoveries on losses claimed in prior years or collections on debts previously deducted as worthless.

"Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. *When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs.* No other system would be practical in view of the statute of limitations, the obvious administrative difficulties involved, and lack of finality in income tax liability, which would result. The foregoing principles, which have been established by the following cases, require that the refund here be included in the income of this estate for the year of recovery. (Citations omitted)

Most of the foregoing cases are ones in which a taxpayer had been allowed to take a deduction, as for taxes, expenses, losses of bad debts, and in a later year had recovered all, or a part, of the item previously deducted. The uniform holding was that, since the amount recovered had been allowed previously to offset income, it should be reported as a part of gross income for the year in which it was recovered. Those cases cannot be distinguished in principle from the present case." (Emphasis added) *Id.* at 341-342.

It should be noted that the language and reasoning of the Board in the above quotation is similar to that which was used in its earlier decision in *South Dakota Concrete Products Co.*, one of the cases it cited for these statements. But whereas the *South Dakota Concrete* opinion used the phrase "when an adjustment occurs which is inconsistent with what has been done in the past," the *Block* opinion modified it to read "when *recovery or some other event* which is inconsistent with what has been done in the past occurs. . . ." (Emphasis added) What the Board meant by an "inconsistent event," other than a recovery, was not clearly stated. But when that statement is read in the context of the

Board's entire explanation, along with the cases cited by the Board, it seems most likely that the Board meant only to refer to those situations comparable to a recovery to which we have referred previously — *i.e.*, where a liability has been accrued and deducted but then is later cancelled or extinguished without actual payment. (See dissenting opinion in *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 65 TC 440, at 451.)

The Government, however, has given a much broader interpretation to this language, taking the position that it means any event deemed to be inconsistent with the earlier deduction can trigger an application of the tax benefit rule; and that this is true, moreover, in cases where the deduction was based on an actual payment of the expense by the taxpayer even though the taxpayer never recovers the payment or its equivalent. Rev. Rul. 74-396, 1974-2 CB 106.

In its brief to this Court, the Government does not attempt to explain what the *Block* Board itself meant by its *dictum*. Indeed, the only place Block is even cited is in a footnote, where it is simply included along with the other decisions which have repeated the "inconsistent event" language. (Govt's. Br. p. 27, n. 18.) Instead, the Government now places its heaviest reliance and emphasis on another Board of Tax Appeals decision, *Barnett v. Commissioner*, 39 B.T.A. 864 (1939). (Govt's. Br. pp. 9, 22-23, 27.) The Government cites this case "and its progeny" (which "progeny" are not identified) as cases "in which no recovery, either actual or constructive, could be attributed to the taxpayer." (Govt's. Br. pp. 22-23, 27, n. 18.)

But the Government's analysis of *Barnett* is patently incorrect and that decision in no way supports the Government's present interpretation of the tax benefit rule. There, the taxpayer owned some land which she leased to an oil company. When the lease was made, the taxpayer received

cash as consideration for making the lease, but 27½% thereof was excluded from her gross income for that year as a deduction for depletion. The lease was terminated in the following year as to a substantial portion of the acreage it covered, without any mineral substances having been extracted. The applicable depletion regulations specifically provided that if depletion was allowed with respect to an advance royalty or bonus and no production occurred during the life of the lease, the lessor was required to restore to his capital account and report as income in the year the lease terminated, the amount which had been allowed as depletion deductions. Based squarely on such regulation, the Board held that the taxpayer was required to restore to income in 1935 the portion of the depletion she had been allowed in 1934 allocable to the acreage as to which the lease had expired.

The Board could have simply stopped there, resting its decision on a valid regulation, but instead it went on to make the following statement to justify the result:

> "Finally, the present case is analogous to a number of others, where with or without a supporting regulation, an adjustment has been made during the taxable year in which actually no income was received. See *Estate of William H. Block*, 39 B.T.A. 388, and many cases there cited. See also *Houbigant, Inc.*, 31 B.T.A. 954; aff'd. per curiam, 80 Fed. (2d) 1012. Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359. When some event occurs which is inconsistent with the deduction taken in a prior year, adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs. This petitioner was able to offset a portion of the payment received in 1934 by a deduction for depletion and thus escape income tax

on that portion of the payment. The deduction allowed for 1934 was proper but was granted conditionally. The petitioner by accepting the reduction also accepted the condition provided in the regulations. Depletion is an allowance made for exhaustion of the property. The lease was terminated in 1935 without any exhaustion ever having taken place. The petitioner thereupon became required under the regulations to restore to income the amount previously allowed as a deduction in respect to the 241 acres. There was no error in the determination of the Commissioner." *Barnett v. Commissioner, supra* at 867-868.

While the Government relies heavily on the Board's statement that "the present case is analogous to a number of others, where, with or without a supporting regulation, an adjustment has been made during the taxable year in which actually no income was received," the Government's brief omits the Board's citation to the supposed "other cases" from the quotation in its brief. (Govt's. Br. p. 23.) As we have shown, *Block* in fact involved an actual recovery of a tax refund, and most of the other cases cited therein involved actual recoveries. The remaining cases involved cancellation or reduction of accrued liabilities or expenses, which is the economic equivalent of a recovery. Likewise, both *Houbigant, Inc. v. Commissioner*, 31 B.T.A. 954 (1934) and *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) involved actual recoveries.

What the Board undoubtedly meant, thou[illegible] choice of language was less than precise, was that the facts in *Barnett* were somewhat analogous to those tax benefit rule cases involving accrued liabilities and expenses which are later cancelled or reduced without actual payment. That is, the taxpayer had received a depletion deduction offsetting a portion of her income in the year of deduction even though

she had not yet incurred any actual cost — *i.e.*, she had not paid out any money or lost anything. The "cost" she was deducting actually would be incurred only if, as and when minerals were extracted from the property under the lease, thereby depleting her property. When the lease was terminated without such extraction, the assumed cost would not be incurred and her net worth was thereby increased in a manner similar to what occurs when an accrued liability is extinguished without payment.

Our analysis is supported by this Court's decision in *Douglas v. Commissioner*, 322 U.S. 275 (1944). As the Government correctly points out, *Douglas* reached "the same result" as *Barnett*. (Govt's. Br. p. 9, n. 7, p. 22, n. 14.) But *Douglas* and the "progeny" of *Barnett* did not reach that result based on the tax benefit rule. Rather, it was based solely on the specific regulation covering depletion.[6] In upholding the reasonableness of that regulation, this Court stated a rationale which is preferable to the *Barnett* analogy:

> "The manner in which the Commissioner exercised that power by attributing the sums restored to basis to the 1937 income, rather than to the years 1929 to 1936, is not invalid as an arbitrary penalty or an improper

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[6]While the rationale for the depletion regulation may be similar in some respects to the rationale for the tax benefit rule, the two rules are mutually exclusive. As previously mentioned, Regulation Section 1.111-1(a) extends the statutory "recovery exclusion" to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years . . . *but not including deductions with respect to* depreciation, *depletion*, amortization, or amortizable bond premiums." (Emphasis added) Depletion deductions claimed by a lessor on a bonus or advance royalty must be included in income in their entirety upon termination or abandonment of the lease prior to production, even if no tax benefit was realized from the deduction. *Louisiana Delta Hardwood Lumber Co. v. Commissioner*, 12 T.C. 576, 580 (1949); *Merten's Law of Federal Income Taxation*, Vol. 4, Sec. 24.24, p. 119.

attribution under the theory of an annual period for determination of income taxes. On the termination of the lease, the lessee surrendered the right to extract without royalty the ore for which royalty had been prepaid. *This surrender returned to the taxpayer in 1937 a legal right.* Thereupon the taxpayer was in position to again sell the right to extract this ore or to mine that selfsame ore itself. The record does not show any valuation of this right which the lessee surrendered. The lessee paid for the right the amount attributed to the petitioners' income. Irrespective of the actual value of the right in 1937, it does not seem unfair for a general regulation to put this value on the right restored to the taxpayer in the year of its restoration. The decisions uphold the regulation. (Citations omitted)

The restoration of the right to petitioners in 1937 is analogous to the surrender of a leasehold, improved by the lessee, to the lessor. In such a case, the value of the improvements is income to the lessor at the time of the surrender. (Citations omitted)" (Emphasis added) 322 U.S. at 285-287.

Thus, contrary to the Government's interpretation, even the depletion cases like *Barnett* and *Douglas* do not represent situations where prior years' deductions were taxed without any recovery in the year of taxation. What was recovered was the right surrendered by the lessee back to the lessor upon termination of the lease. Such right was simply valued, for tax purposes, by the amount of the previously claimed depletion deductions.

III.

Tennessee-Carolina Transportation, Inc., and Cases Following That Decision, Are Based on Faulty Reasoning and, in Any Event, Do Not Justify the Rule Now Being Urged to This Court by the Government.

To our knowledge, the first decision actually holding that the tax benefit rule may be based solely on a so-called "inconsistent event," without any recovery or its economic

equivalent, was rendered by the Sixth Circuit Court of Appeals in *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), aff'g 65 T.C. 440 (1975). Before discussing this important decision, however, we believe it will be instructive first to review the reasoning of the Tax Court majority and dissent. The case involved a liquidation by a parent corporation of a wholly owned subsidiary governed by Sections 334(b)(2) and 336 of the Internal Revenue Code. In the liquidation, the subsidiary distributed to the parent certain tires and tubes the cost of which had been deducted as expenses during the last year of the subsidiary's operation. Despite Section 336 of the Internal Revenue Code, which provides that a corporation shall not recognize gain or loss on the distribution of property in liquidation, the Tax Court majority held that the subsidiary was required to include in gross income in the year of liquidation, the lesser of the fair market value of the tires and tubes so distributed or the portion of their cost attributable to their remaining useful life. The majority based this holding on the theory that the tax benefit rule was applicable and operated to exclude the tires and tubes from the provisions of Section 336.

The taxpayer had argued that the tax benefit rule was inapplicable because the subsidiary did not receive or have a right to receive any money or property in exchange for the tires and tubes, relying on *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837, 839-840 (9th Cir. 1963). But the Tax Court's majority rejected that argument, as follows:

> "In our opinion the understanding of 'recovery' upon which the decision of the United States Court of Appeals for the Ninth Circuit in *South Lake Farms, Inc.* rests is unduly restrictive. It is well established, for example, that an item of expenditure that has been properly accrued but not paid is deemed to be recovered

when liability for the item terminates. *Bear Manufacturing Co. v. United States*, 430 F.2d 152 (7th Cir. 1970), cert. denied 400 U.S. 1021 (1971); *Mayfair Minerals, Inc.*, 56 T.C. 82 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972). This leads us to conclude that for purposes of the tax benefit rule, a taxpayer may have recovered an item previously expensed although *actually* he has neither received nor become entitled to receive money or property. See *Estate of William H. Block*, 39 B.T.A. 338, 341 (1939), affd. sub nom. *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir. 1940).

Service was permitted to expense the cost of the tires and tubes which it purchased, on the assumption that their useful life would be fully exhausted in its operations. Once Service had expensed their cost, the tires and tubes were therefore deemed to have been fully consumed in its operations for purposes of Federal income taxation whatever their fair market value may have been. If having expensed the cost of the tires and tubes Service subsequently treated them as property having a fair market value in a transaction of consequence in the scheme of Federal income taxation, it would therefore necessarily be deemed to have received tires and tubes identical to them immediately prior to that transaction. *Anders v. United States*, 462 F.2d 1147, 1149 (Ct. Cl. 1972), cert. denied 409 U.S. 1064 (1972); *Spitalny v. United States*, 430 F.2d 195, 197-198 (9th Cir. 1970)." 65 T.C. at 447.

Thus, although it cited *Block* for a point for which it does not truly stand (as we have demonstrated *supra*), the Tax Court did not seem to directly base its decision on the "inconsistent event" rationale, but on an assumed recovery of the tires and tubes. Judge Simpson of the Tax Court wrote a concurring opinion to emphasize that he believed there was a recovery. The dissenting opinion by Judge Tana-

wald, joined by six other judges, disagreed with the majority on the ground that there was no recovery. The dissenting opinion cogently analyzes the authorities relied upon by the majority, pointing out that in every instance "there was a present economic benefit either by way of an actual receipt of funds or a release of a liability resulting in an increase in the taxpayer's net worth." 65 T.C. at 450. The dissent further pointed out that the only apparent authority for a broader reading of the word "recovery" was *Block*, and that the "inconsistent event" language of that opinion was *dictum*. The dissent further expressed the view that "to the extent that the majority reads *Block* to sanction the application of the tax benefit rule where the only event is the cessation of need for the prior deduction," such approach was contrary to that taken by this Court in *Nash v. United States*, 398 U.S. 1 (1970).

The Sixth Circuit affirmed the Tax Court's decision based upon a belief that the result in a liquidation governed by Internal Revenue Code Section 336 should be comparable to what would have occurred had the liquidation been governed by Section 337. In response to the taxpayer's argument that regardless of any disparity in treatment under the two code sections, the tax benefit rule could not be applied without a recovery, the Court of Appeals held as follows:

> "First, there need not be an actual physical 'recovery' of some tangible asset or sum in order to apply the tax benefit rule. The tax benefit rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept which is necessary for administration of the tax laws. The rule should apply whenever there is an actual recovery of a previously deducted amount *or* when there is some other event inconsistent with that prior deduction. See *Block v. Commissioner*, 39 B.T.A. 338, 340-341 (1939),

> *aff'd. sub nom Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.) cert. den. 311 U.S. 658, 61 S. Ct. 12, 85 L. Ed. 421 (1940). Here the transfer to taxpayer with a stepped-up basis, pursuant to § 334(b)(2), of the tires and tubes which had a substantial useful life remaining was inconsistent with the prior expensing of them, which indicated they had been or would be totally used up by Service. This inconsistency is enough to invoke the tax benefit rule." 582 F.2d at 382.

In so holding, the court expressly rejected what it considered to be the contrary holding of the Ninth Circuit Court of Appeals in *Commissioner v. South Lake Farms, Inc., supra*. But the court went on to hold that if a recovery is required in order to apply the tax benefit rule, there was such a recovery, although the court acknowledged that it was a "fictional recovery."

In a concurring and dissenting opinion, Judge Weick dissented to the portion of the majority's judgment which held the tax benefit rule applicable to a liquidation in kind under Internal Revenue Code Section 336. The opinion criticized the majority's reasoning on the same grounds as those expressed by the dissenters in the Tax Court. After pointing out that the language from *Block*[7] relied upon by the majority was only *dictum*, Judge Weick states:

> "Neither the majority, the majority of the Tax Court, nor the Commissioner has cited a single case in which the tax benefit rule has been applied solely on the basis of the occurrence of an event which was inconsistent with a previous deduction. To the contrary, the salient

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[7]It is interesting to observe that the case on which the Government now appears to place its greatest reliance, *Barnett v. Commissioner*, 39 B.T.A. 864 (1939) is not even mentioned in any of the opinions in *Tennessee-Carolina Transportation, Inc.*

> feature of every case cited by them, in which the rule was applied, is the presence of an actual economic recovery by the taxpayer, either (1) by way of receipt of funds (citations omitted) or (2) by way of discharge of an accrued liability resulting in an increase in the taxpayer's net worth (citations omitted). Furthermore, the regulations under the statutory tax benefit rule, 26 U.S.C. Section 111, require that there be an actual recovery of the prior tax benefit. Treas. Reg. §1.111-1." 582 F.2d at 384.

As we have demonstrated herein, this criticism of the majority opinion in *Tennessee-Carolina* is well taken. The Government *still* cannot point to a single case, other than *Tennessee-Carolina* and the cases which have followed the majority's reasoning, in which the tax benefit rule has been applied solely on the basis of the occurrence of an event which was inconsistent with a previous deduction.

The *Tennessee-Carolina Transportation* decision was followed by the Seventh Circuit Court of Appeals in *First Trust & Savings Bank of Taylorville v. United States*, 614 F.2d 1142 (7th Cir. 1980), wherein the court also placed its decision on alternative grounds — *i.e.*, that no recovery was required, but if it was, a sufficient recovery had occurred. The recovery was based on the fact that the bank was named as a joint payee of the tax refund checks in question, along with the shareholders to whom the checks were endorsed by the bank. Indeed, the court believed this "recovery" by the bank "was considerably more palpable than the 'deemed' recovery made by the subsidiary at the moment of liquidation in *Tennessee-Carolina Transportation*." 614 F.2d at 1146. But in *Hillsboro National Bank v. Commissioner*, 641 F.2d 529 (7th Cir. 1981), the court could not and did not rely on the alternative ground of a recovery, because the tax refunds there were paid directly to the shareholders,

and the court was compelled to rest its decision solely on the "inconsistent event" rationale as expressed in *Tennessee-Carolina Transportation* and followed in *First Trust & Savings Bank of Taylorville*. But in neither of the Seventh Circuit decisions did the court make any effort to answer the criticism of the "inconsistent event" rationale expressed by the dissent in *Tennessee-Carolina Transportation*.

In constrast with *Tennessee-Carolina Transportation* and its "progeny" (to borrow the Government's term), we believe the Ninth Circuit's decisions in *South Lake Farms* and *Bliss Dairy*[8] are fully in accord with the tax benefit rule as it is expressed in the statute and regulations and overwhelming bulk of judicial authority, including this Court's decision in *United States v. Nash, supra*.

Finally, we also believe that the Fifth Circuit Court of Appeals' decision in *Putoma Corp. v. Commissioner*, 601 F.2d 734 (5th Cir. 1979) is contrary to the *Tennessee-Carolina Transportation* rationale. There the taxpayer corporations had accrued and deducted interest which they owed to one of their shareholders but never paid. The court held that the corporations did not realize taxable income

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[8]The Government contends that the Ninth Circuit of Appeals' decision in *Home Savings & Loan Association v. United States*, 514 F.2d 1199 (9th Cir. 1975) cannot be reconciled with *South Lake Farms* and *Bliss Dairy*. (Govt's. Br. pp. 43-44, n. 32.) But the Government's analysis of that case is totally incorrect. The sole issue there was whether the particular transaction in question constituted a "reorganization" within the meaning of Internal Revenue Code Section 368(a)(1)(A). The court held that the transaction was not a reorganization. The opinion does not discuss the tax benefit rule at all and the court expressly said that nothing in the opinion was intended to impair the authority of *South Lake Farms*. 514 F.2d at 1201, n. 1. In particular, it should be noted that there is absolutely no statement in the opinion which justifies the Government's claim that "the court viewed the liquidation and distribution as an event inconsistent with the former corporation's prior deductions for the reserves." (Govt's. Br. p. 44, n. 32.)

under the tax benefit rule when the shareholder cancelled their liability for the accrued interest, because under applicable provisions of the Internal Revenue Code, the cancellation constituted a non-taxable contribution to capital. This was true notwithstanding the fact that the cancellation of the accrued liability clearly was a recovery under existing case law, and despite the fact that the corporations retained the benefit of the earlier deductions. The court reasoned, *inter alia*, that the judicially created tax benefit rule could not take precedence over governing code provisions. 601 F.2d at 743.

Conclusion.

For the foregoing reasons, the judgment of the Ninth Circuit Court of Appeals in *Bliss Dairy* should be affirmed. This Court should not adopt the Government's position that it can invoke the tax benefit rule against a taxpayer when there has been no recovery or its economic equivalent with respect to a previous deduction, based solely on some alleged "inconsistent event." Especially, the Government should not be permitted to do so when the realization of income would be contrary to specific statutory provisions and regulations governing the tax treatment of the underlying transaction or events.

Dated July 16, 1982.

Respectfully submitted,

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Amicus Brief

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No. 81-930
IN THE

Supreme Court of the United States

October Term, 1981

UNITED STATES OF AMERICA,
Petitioner,

vs.

BLISS DAIRY, INC.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF OF AMICUS CURIAE.

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No. 81-930

IN THE

Supreme Court of the United States

October Term, 1981

UNITED STATES OF AMERICA,

Petitioner,

vs.

BLISS DAIRY, INC.,

Respondent.

BRIEF OF AMICUS CURIAE.

INTEREST OF AMICUS CURIAE.

This brief of *Amicus Curiae* is submitted in No. 81-930, *United States of America, Petitioner v. Bliss Dairy, Inc.*, in support of the decision below by the Circuit Court of Appeals for the Ninth Circuit, and of the position of taxpayer Bliss Dairy, Inc.

A. *Bliss Case and Pending Case.* As herein used: "*Bliss Case*" refers to the instant case, No. 81-930; "*Pending Case*" refers to a transaction that has recently occurred which in due course will involve audit by the Commissioner[1] and will be affected by this Court's decision in the *Bliss Case*. Proper interpretation of Section[2] 336, prescribing that a corporation realizes no taxable gain or loss from distri-

[1]Commissioner of Internal Revenue, which includes reference to the Internal Revenue Service.

[2]As herein used "Section" or "Subsection", without other designation, refers to the Internal Revenue Code of 1954, as amended.

bution of property in liquidation, is the issue central to both cases.

B. *Bliss Facts and Commissioner's Position.* Briefly stated, the *Bliss Case* facts are: dairy corporation was liquidated in one month under Section 333; its assets, including cattle feed, were distributed in liquidation, an event stated by Section 336 to cause no taxable gain or loss; pursuant to Section 334(c), the stockholders' tax basis for the distributed assets was determined by allocating thereto the stockholders' cost of their stock;[3] because the corporation used cash accounting and had deducted the cost of purchased feed, the Commissioner is attempting to tax the corporation upon the value of feed distributed in liquidation, which would violate Section 336 and result in double-taxation unintended by the statutes.

C. *Pending Facts and Commissioner's Position.* The *Pending Case* facts are as follows: For a number of years before 1981 five co-venturers were engaged in the farming business, principally sod growing. In early 1981 negotiations were undertaken by four co-venturers with shareholders of the fifth, a corporation (herein "Sod Corporation"), to purchase 85% of Sod Corporation's stock. The price was negotiated by reference to the values of Sod Corporation's assets, consisting of its venture share of land, depreciable orchard trees, buildings, equipment, growing sod crops, supplies, receivables and miscellaneous items. Buyers wanted assets, but sellers were willing only to sell stock.

Promptly after the stock purchase, buyers liquidated Sod Corporation. Pursuant to Section 334(a) the stock price is being allocated to the distributed assets according to their respective values. The venture used cash accounting, thereby taxably expensing the cost of growing and acquiring sod crop and supplies, and deferring taxation of receivables until collected. Sod Corporation asserts Section 336 ex-

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[3]Possibly with adjustments required by Section 334(c).

emption from income tax upon liquidation distribution of its interest in the farming business assets, including those items.

Computation of the sellers' taxable gain from sale of their stock includes values assigned to those items in the stock price negotiation, thereby subjecting them to income taxation.[4]

If the Ninth Circuit's decision in the *Bliss Case* were reversed by this Court: the Commissioner would seek income tax from Sod Corporation upon the values of its interest in distributed crop, supplies and receivables; which would improperly impose income tax upon the purchasers at point of purchase, prior to the realization of any gain or loss; and, since the sellers are being taxed on the same values, would effect improper double taxation. The *Pending Case* involves a California (Ninth Circuit) transaction.

D. *The Tax Statutes and the Commissioner's Litigating Policy*. Amicus Curiae wishes to present to this Court a general concern that the tax statutes should be observed as written by Congress, not distorted by a litigating policy undertaken by the Commissioner to achieve variations from the statutory words and plan.

SUMMARY OF ARGUMENT.

Section 336 is part of a statutory pattern that generally exempts a liquidating corporation from tax, but taxes the stockholders who receive distribution of its assets, or the former stockholders who sold its stock, on gain measured by the difference between their stock cost and the value of those assets. Within that general rule, Section 333, combined with Section 336, permits stockholders to liquidate a corporation with little or no taxable gain to themselves and none to the corporation, transfer their stock cost to the corporate assets as tax basis, defer their own taxable gain

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[4]As capital gain under Section 331(a)(1) or, if the corporation is "collapsible", as ordinary income under Section 341.

until they dispose of the assets. There are statutory exceptions to the general rule but none applies here.

The words of Section 336 expressly prohibit the Commissioner from taxing the liquidating corporation upon the distribution of its assets. Over the years the Commissioner has attempted to circumvent the statutory words, and tax the liquidating corporation, by advancing a variety of untenable theories designed to accomplish judicial legislation. He has been unsuccessful in this Court and two lower appellate courts. He has succeeded in other lower courts whose opinions reflect confusion.

This court should affirm the decision of the Ninth Circuit in the *Bliss Case*, affirm the authority of Section 336 and the statutes that surround it.

ARGUMENT.

I.

The Issue Is Whether the Commissioner May Tax a Corporation Upon Distribution of Assets in Liquidation, Contrary to Section 336 in Particular and the Statutory Pattern in General.

A reading of the Government's brief would lead one to believe that the issue in this case is whether a corporation may avoid taxation of income which allegedly should be taxed according to annual tax accounting and the tax benefit rule. Not so.

Section 336(a) states:

> "(a) GENERAL RULE.—Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

The issue here is whether the Commissioner may tax a corporation's liquidating distribution of property contrary to those plain statutory words.

This Court might wonder why the Government's brief goes through such lengthy argument and cites so many lower court cases with reference to such a simple issue. The answer lies in the Commissioner's policy, pursued over the years, in and out of court, to tax a liquidating corporation in a variety of circumstances not permitted or intended by the words of Section 336, the words of the related Section 337 (which sanctions tax-free sales by a liquidating corporation) or the statutory pattern surrounding those Sections. We submit that the Commissioner's policy has been and is misguided.

This Court has not considered the Commissioner's policy toward Sections 336 and 337 for many years. Meanwhile serious confusion in this area of tax law has arisen through

lower court decisions. A clear understanding of the pattern of pertinent tax statutes is necessary to eliminate the confusion. Begging the Court's indulgence, we shall proceed to describe that pattern.

II.

Congress Has Provided an Elaborate Statutory Tax Pattern Governing Corporate Liquidations. Section 336 and Surrounding Statutes Exempt the Corporation, Tax the Shareholders.

II.A. *Elaborate Statutory Pattern.* Congress has carefully provided a statutory pattern for taxing corporate liquidations which is elaborate and comprehensive, and would be distorted by the kind of interpretative variation which the Commissioner proposes here.

II.B. *General Rules.* Subject to specific exceptions discussed below, the general statutory rules in this area are as follows.

II.B.1. *Normal Liquidation.* In a normal corporate liquidation: the corporation is not taxed upon distribution of its property (Section 336); the distributee-stockholders realize taxable gain or loss measured by the difference between stock cost and fair market value of property distributed (Sections 331(a), 1001) and get a new basis in the property distributed equal to its fair market value (Section 334(a)); if the stock was purchased, this effectively means that the stock price is allocated to the distributed property as the buyer's basis, the selling stockholders have realized taxable gain or loss determined by comparing that price with their basis in the stock (Section 1001).

II.B.2. *Liquidation of Subsidiary Corporation by Its Parent.* If the liquidating corporation is the subsidiary of a parent corporation,[5] the liquidation is tax-free to both

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[5]As herein used "parent" and "subsidiary" corporations mean those where an 80% or more control exists as provided in Section 332(b)(1).

corporations (Sections 332, 336); the distributee-parent takes over the subsidiary's basis in distributed property (Section 334(b)(1)); in other words, the assets remain in corporate solution without tax consequences. But if the parent has bought the subsidiary's stock within two years of the liquidation, the parent allocates the stock price to the distributed property as basis (Section 334(b)(2));[6] the subsidiary is absolved from tax by Section 336; the seller of the stock realizes taxable gain or loss upon the sale (see II.B.1. above).

II.B.3. *Sale of Corporate Assets During Liquidation.* If a corporation sells its assets and distributes the proceeds within twelve months after adopting a plan of liquidation: the corporation realizes no taxable gain or loss on the sale (Section 337(a));[7] the stockholders realize taxable gain or loss measured by the difference between proceeds distributed and stock cost (see II.B.1. above). But if the purchaser is a parent corporation liquidating a subsidiary tax-free under Section 332, the subsidiary is absolved from taxable gain or loss on sale of its assets only if its stock was purchased by the parent within two years before liquidation (Section 337(c)(2)), that is, in a case where the parent gets a new basis in distributed assets and the stock seller realizes taxable gain or loss (see II.B.2 above).[8]

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[6]Subject to adjustments related to events occurring between stock acquisition and liquidation, as prescribed by Section 334(b)(2).

[7]With exceptions such as that for inventory-type property which is sold other than in a one-purchaser transaction. Subsections (b) *et seq.* of Section 337.

[8]Examples of Congressional attention to detail in this area include Section 337(d) providing that if the selling subsidiary is taxed, in a Section 332 situation where Section 337(a) does not apply, and if the parent owns between 80% and 100% of the subsidiary's stock, minority stockholders of the subsidiary are treated as though Section 337(a) did apply, *i.e.*, their gain is increased and their tax on gain reduced by a pro rata part of the subsidiary's gain tax.

The Congressional purpose to prevent double tax when a corporation liquidates is underscored by Section 337. That Section was designed to counteract *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) which had supported the Commissioner's imposition of tax on the liquidating corporation as though it had sold assets, while taxing the stockholders on their gain from actual sale of the corporation's stock.

II.B.4. *One Month Liquidation.* If a corporation liquidates and distributes its assets in one month, Sections 333 and 334(c) enable qualified electing stockholders to avoid tax on the distribution by transferring their stock basis to the distributed property; thus deferring taxable gain on that property until its subsequent disposition by them.[9] The liquidating corporation is absolved from taxable gain or loss by Section 336.

II.C. *Specific Statutory Exceptions to the Rule Against Double Taxation of a Corporate Liquidation.* There are detailed statutory exceptions to the general rule that a liquidating corporation realizes no taxable gain or loss from property distributions (Section 336), or from property sales (Section 337).

II.C.1. *Inventory.* A distribution of LIFO inventory by a liquidating corporation is treated like a sale, with realization of corporate taxable gain equal to the "LIFO Recapture Amount," that is, the excess of first-in first-out inventory amount over LIFO (last-in first-out) amount. Section 336(b). If a corporation being liquidated under Section 337 sells inventory (or other property held for sale to customers) it realizes taxable gain or loss thereon; unless sub-

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[9]Section 333 eliminates only gain, not loss. Some gain may be taxed by reference to accumulated earnings of the liquidating corporation or cash and securities distributed. Sections 333(e) and (f). Property basis is increased by any such gain to stockholders, reduced by any cash distributed. Section 334(c). A 50% + corporation-stockholder does not qualify for this treatment. Section 333(b).

stantially all thereof is sold to one person in one transaction, in which case the sale has no tax consequences except for the LIFO Recapture Amount. Subsections (b) and (f) of Section 337.

II.C.2. *Depreciation Recapture.* A liquidating corporation is taxed under Sections 1245 and 1250: on income equal to the excess of price or value of property sold or distributed over its adjusted basis; to the extent matched by depreciation taken on personal property; but only to the extent of the excess of rapid depreciation over straight-line depreciation taken on buildings.[10]

II.C.3. *Installment Obligations.* When payment of the sale price for property is deferred (*i.e.* paid in installments) gain is taxed pro rata as the price is collected,[11] loss is deductible only at time of sale (Section 453); taxation of the deferred gain included in an installment obligation is accelerated upon its disposition, by reference to the price received for it, if sold, otherwise to its value (Section 453B). A distribution in liquidation is such a disposition, taxable to the corporation, unless the obligation was created by a Section 337 sale in which case the corporation generally escapes tax, the shareholders are taxed on deferred gain as installments are collected by them. Sections 453B(d), 453(h).

II.D. *Congress Has Prescribed Section 341 as the Remedy Where a Corporation Is Sold or Liquidated to Avoid Taxation of Its Income.* A so-called "collapsible" corporation is classically one that is used to acquire, construct or produce inventory-type property which is distributed in liquidation before major realization of corporate income

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[10]Subsections (a) and (b) of Section 1245, Subsections (a), (b) and (c) of Section 1250.

[11]Unless the taxpayer otherwise elects.

therefrom.[12] Former result: the stockholders were taxed at capital gain rates on liquidation or sale of their stock; corporate income tax was avoided.

To close this "loop-hole", Congress enacted Section 341. This statutory remedy does not impose double-tax, *i.e.* does not first tax the corporation on its income, then tax the stockholders on their gain. Instead it provides that the gain realized from stock sale or corporate liquidation shall be taxed to the stockholders as ordinary income. If Section 341 applies, neither Section 333 nor Section 337 is available. Section 333(a); Section 337(c)(1)(A). By its Section 341 attention to and provision for correction of tax avoidance by a liquidating corporation, Congress has implied that the Commissioner should not provide additional correction of his own. Indeed, Section 341 is a statutory acknowledgement that corporate income may go untaxed at liquidation; the remedy provided, if the problem is serious, being to tax the stockholders more heavily, not to restore the corporate tax.

II.E. *Summary: When a Corporation Liquidates the Stockholders Are Taxed, the Corporation Is Not.* The statutory pattern may be summarized as follows.

II.E.1. *The General Statutory Rule: Only the Stockholders Are Taxed, Double Taxation Is Avoided.* A tax-free liquidation of a subsidiary, into a parent that has long owned its stock, leaves the assets in corporate solution. The parent takes over the subsidiary's tax basis in the assets distributed.

A taxable liquidation, by contrast, is taxable to the corporation's stockholders. Their taxable gain or loss is the difference between the value of corporate assets distributed to them and the cost of their stock. If they have just bought

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[12]As herein used "capital gain" refers to long-term capital gain which generally receives favorable tax treatment. Sections 1201, 1202, 1221, 1222, 1223, 1231.

the stock they realize no gain or loss because asset value matches stock price; but the selling stockholders realize taxable gain or loss measured by the difference between price received and stock cost. These rules apply not only to individuals, but also to a corporation that buys or sells the stock of another corporation.

The liquidating corporation is shielded from tax by Section 336, if it distributes assets, Section 337 if it sells them.

Thus the statutory plan for corporate liquidation provides relief from the double taxation that occurs when a continuing corporation pays tax on its income, the stockholders pay tax on its dividends.

Section 333 fits into the plan by permitting stockholders to liquidate a corporation without tax to it (Section 336), and with little or no tax to themselves at time of liquidation. The trade-off is that the corporate basis in the distributed assets disappears, the stockholders' stock cost is substituted therefor. Result: sooner or later the stockholders will realize taxable gain or loss from those assets measured against original stock cost, providing single-tax treatment comparable to that for an ordinary corporate liquidation.

II.E.2. *The Tax Accounting Wall at Liquidation.* When a taxable liquidation occurs, a wall is erected between the tax accounting system of the liquidating corporation, which terminates, and the tax accounting system that starts for the stockholders. The liquidating corporation's tax basis in its assets entirely disappears, along with its stock and corporate existence. A new basis begins for the stockholders measured by the value of the same assets, entirely unrelated to the disappearing corporate basis.

It matters not whether the corporation's basis in an asset was $100,000 or zero; the stockholders will take a new basis equal to its value. If that value is $50,000, and the stockholders subsequently sell the asset for $100,000, the stockholders will realize taxable gain of $50,000; it is immaterial

that, if the corporation had sold the asset, it would have had a taxable loss or gain of $50,000, depending on its basis.

The accounting method and period will change at the wall; stockholders will thereafter use their own; those of the liquidating corporation disappear. Cf. Sections 441, 446. There is no further effect of the corporation's holding period in the distributed assets for such purposes as determining whether a sale would produce ordinary income or long term capital gain. The stockholders start a new holding period, which may involve some tacking of the holding period for their stock in Section 333 or 334(b)(2) situations. Cf. Section 1223; *Cabax Mills v. Commissioner*, 59 TC 401 (1972).

II.E.3. *Tax Trade-Off Between Corporation and Stockholders*. Liquidation can impose a tax burden on the stockholders that is far heavier than any tax saving to the corporation. If they have long owned a successful corporation and liquidate it or sell its stock, they will be picking up a large taxable gain over their stock-cost basis, measured by all of the corporate asset values which include not only appreciation over the corporation's basis, but also substantial tax-paid corporate earnings. The tax collected by the Commissioner from the stockholders on this one-time (perhaps once in a lifetime) event will far over-match any tax that the corporation may have avoided by not continuing in operation until it has realized all income items and recovered all deductions.

II.E.4. *Significance of the Statutory Exceptions Which Tax the Liquidating Corporation*. The general rule shielding the liquidating corporation from tax is underscored by the specific statutory provisions that tax the corporation in certain respects. Statutory attention to the detail that an income item like inventory is to be taxed only in certain respects (LIFO Recapture Amount and, if Section 337 is involved, multiple sales) reflects a purpose not to tax other income items.

Statutory attention to recapture of an expense item like depreciation (but not straight line depreciation on buildings) reflects a purpose not to recapture other expense items. Statutory attention to taxing the untaxed gain in installment receivables (but not those created by Section 337 sales) reflects a purpose not to tax deferred income or gain in other receivables.

None of the statutory exceptions being applicable, the liquidating corporation is protected from tax in the *Bliss Case* and *Pending Case*.

II.E.5. *Significance of Section 341 Concerning Collapsible Corporations*. The Commissioner expresses particular distaste if a corporation appears to escape ordinary income tax by liquidating. Section 341 makes it clear that liquidating conversion of corporate ordinary income tax into stockholder capital gain tax is intended by the statutory pattern unless a serious abuse of the liquidating process has occurred, and if it has, ordinary income tax is imposed upon the stockholders' entire gain. Whether or not there has been such abuse, the corporation is not to be taxed.

II.E.6. *The Commissioner's Litigating Policy Should Not Be Permitted to Disrupt the Statutory Pattern*. The statutory pattern governing taxation of a liquidating corporation and its stockholders is comprehensive and detailed. It should not be altered or frustrated by administrative or judicial interpretation such as the Government proposes in the case at issue. This brief now proceeds to a discussion of the Commissioner's policy of litigating to change the statutory pattern and, in particular, to override Sections 336 and 337.

III.
What the Commissioner Advocates Here Would Abuse the Legislative Process.

III.A. *The Commissioner Is Attempting Judicial Legislation*. When tax statutes are being drawn there is input from Treasury, Administration, taxpayers, Congressmen,

the House Ways and Means Committee, the Senate Finance Committee and the Conference Committee, with drafting aid from the Joint Committee on Internal Revenue Taxation and its professional staff. This legislative process is calculated to achieve a comprehensive statutory pattern that balances the Treasury's position against reasonable treatment of taxpayers in various affected situations; and to do so prospectively, forewarning taxpayers rather than entrapping them.

Such a result can not be accomplished by litigating tax cases one at a time. However, the Commissioner sometimes does that, and does it effectively, with his large staff and relatively unlimited budget. When this happens the taxpayer finds it hard to furnish and finance adequate opposition in his particular case; and the courts tend to be impressed by the power of the Commissioner's presentation.

In selecting the cases he prefers to litigate, the Commissioner can take advantage of the loose arrangement for court review of income tax disputes, namely: at first impression, the specialized Tax Court, whose twenty travelling judges confer irregularly, or, in the alternative, the unspecialized District Courts and Court of Claims; appellate review by one of ten unspecialized Circuit Courts of Appeal. Not surprisingly, the Circuit Courts frequently differ on a tax issue; their conflicts are seldom promptly settled by this Court.

The tax benefit rule has been established and expanded by this litigating process. The conflict now before this Court affords a good example. When *South Lake Farms*[13] was decided against the Commissioner by the Ninth Circuit he continued to litigate in other circuits. When *Tennessee-Carolina*[13] was decided for him he opposed the taxpayer's application for *certiorari* to the Sixth Circuit. But when the *Bliss Case*, following *South Lake Farms*, was decided against him, he finally sought *certiorari*, eighteen years

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[13]Cited in IV.B.1. below.

after the *South Lake* decision, during which time confusion has mounted.

Now that the issue of the tax statutes vs. the tax benefit rule is before this Court, one has to read to page 43 of the Government's brief before finding any mention of the crucial Section 336.[14] It does seem that discussion should have started with that Section.

III.B. *Difficulties Result When the Commissioner Tries to Override Section 336 With the Tax Benefit Rule.* Difficulties and distortions result when the Commissioner persuades the courts to establish exceptions to the words of a tax statute. Using the tax benefit rule to override Section 336 provides a good example.

III.B.1. *Difficulties With Sections 333 and 334(c) in the Bliss Case.* With exceptions immaterial here, the substituted tax basis of the Bliss Dairy stockholders in the assets distributed to them will be derived by allocating their stock cost among such assets according to respective net fair market values. Section 334(c), Treas. Reg. 1.334-2.

Normally Section 333 is employed to accomplish a tax-free shift of substantially appreciated property from corporation to stockholders, in order that the latter may enjoy single taxation of income and gain from subsequent use and disposition of such property. The stockholders' substituted basis in the distributed property may be less than the corporation's basis before distribution and this might be so even though the corporation has taxably expensed the cost of some assets, as in the case of the Bliss Dairy feed (the *Bliss Case* record does not indicate). Thus the statutory arrangement, which terminates corporate tax accounting and provides a fresh tax accounting start for the stockholders, leaves no sensible way to correlate the corporation's de-

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[14]Other than a listing under STATUTES INVOLVED on page 2.

ductions with the stockholders'; and certainly indicates no such double deduction as the Government's brief implies.

Indeed if the Commissioner were permitted to tax Bliss Dairy corporation on the value of distributed feed he would not thereby increase the stockholders' basis in distributed property by one iota; the stockholders' ultimate taxable gain from disposition of the property would not be reduced; the tax on that gain would be increased by a second (corporate) tax imposed by the Commissioner having no relationship to stock cost. Such double-taxation would manifestly contravene Sections 333, 334(c) and 336.

III.B.2. *Difficulties That Will Spill Over to Related Areas of Tax Law if the Commissioner Overrides Section 336 in the Bliss Case.* If the Commissioner succeeded in applying the tax benefit rule in the *Bliss Case*, he would surely attempt to disregard Section 336 and tax the liquidating corporation in the *Pending Case* on crops, supplies and receivables which it had taxably expensed or not yet taken into taxable income. The tax burden would fall upon the purchasing stockholders, equate to a point-of-purchase tax imposed, before realization of gain or loss, upon the value of purchased assets. Meanwhile the selling stockholders are paying tax on gain measured by the same asset value, and the Commissioner may even pursue them under Section 341 for ordinary income tax instead of capital gain tax; there would be no way for the Commissioner to recompense the purchasing stockholders for tax collected from the selling stockholders.

III.C. *If the Commissioner Is Dissatisfied With Section 336 and the Surrounding Tax Pattern He Should Appeal to Congress.* The Commissioner is well acquainted with the legislative process. If he dislikes Section 336 and the statutory pattern of which it is a part, he should go to Congress where the pattern can be reviewed and a remedy, if needed, prospectively provided in orderly legislative fashion. He should not be permitted to distort the pattern by what

amounts to *ex post facto* judicial legislation, which entraps and penalizes the taxpayers who happen to get involved on a case-by-case basis.

Nothing in this brief intends disrespect for or doubts the sincerity of the writers of the Government's brief and the people who have worked and spoken for the Commissioner over the years. As a former attorney in the Tax Division of the Department of Justice this writer has done that. However, in the course of forty-four years of tax practice this writer has come to believe that interpretative circumvention of tax statutes is misguided, even though attempted in a seemingly good cause.

IV.

Court Interpretation of the Statutory Tax Pattern Concerning Corporate Liquidations.

IV.A. *How This Court Has Interpreted the Statutes.* This Court has not looked at the pattern of tax statutes concerning corporate liquidations since 1966 when it decided *Fribourg Navigation Company v. Commissioner*, 383 U.S. 272. In that key decision, not cited in the Government's brief, this Court considered Section 337, along with Section 167 allowing depreciation deductions. The depreciation recapture provisions of Section 1245 were not yet applicable. The question was whether the corporation was entitled to deduct depreciation on a ship in the tax year when it profitably sold the ship in a Section 337 liquidation. The depreciation was allowed; without any taxable income recovery from sale of the ship: the tax statutes were upheld as written.

Earlier, and prior to the Internal Revenue Code of 1954, this Court had decided *United States v. Cumberland Public Service Company*, 338 U.S. 451 (1950) preventing the Commissioner from taxing gain to the corporation where the stockholders had sold the distributed assets immediately

after liquidation. This Court commented (338 U.S. at p. 455):

> "But Congress has imposed no tax on liquidating distributions in kind or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation."

In *Nash v. United States*, 398 U.S. 1 (1970) the Commissioner attempted to add back a bad debt reserve to the income of a partnership upon tax-free transfer of its assets to a new corporation pursuant to Section 351. The Commissioner's effort was excessive because the corporation stepped into the partnership's shoes as to basis for and reserve against the receivables. However, this Court did not primarily rest its decision upon that fact; rather, its basic reasoning was that the tax benefit rule could not be applied to undermine Section 351(a) which provides that "No gain or loss shall be recognized * * *" when property is transferred to a controlled corporation. 398 U.S. at p. 4.

Although *Lewyt Corporation v. Commissioner*, 349 U.S. 237 (1955) does not involve Section 336 or 337, some of the lower court opinions dealing with these Sections cite the following language of this Court (349 U.S. at p. 240):

> "But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall."

Although this Court's tax decisions in the corporate liquidation area are sparse, they support a strict reading of the tax statutes, reject distortion of statutory words by theories designed to prevent alleged corporate tax avoidance.

In absence of this Court's attention, the lower courts have accomplished a great deal of statutory distortion by the use

of a confusion of theories proposed to them from case to case.

IV.B. *The Lower Court Decisions at Issue Here.* In *Commissioner v. South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963) a subsidiary corporation was liquidated before harvesting a cotton crop but after deducting accrued cultivation expenses. Its stock had just been purchased by a parent corporation; liquidation was tax-free to parent and subsidiary, the parent transferred the stock price to the distributed assets as basis, the selling stockholders presumably realized taxable gain (Sections 332, 334(b)(2), 336; II.B.2. of this brief).

In his Tax Court opinion (36 TC 1027, 1961) Judge Withey concluded that the purchased subsidiary had realized no taxable income from distribution of land-with-crop; and none via reversal of crop expense deduction.

The essence of the Ninth Circuit's affirming opinion is contained in the following language (324 F.2d at p. 839):

> "Section 334 makes the new corporation, for tax purposes, in effect, the purchaser of the assets of the old, even though the new corporation bought stock. But section 336 makes it clear that the old corporation is not the seller of those assets for tax purposes. The tax falls on the actual sellers, the stockholders of the old corporation. Section 336 prevents the imposition of the tax on the old corporation."

That opinion also: rebuffs the Commissioner on Section 446(b) because the litigating corporation's accounting method was proper; rejects the tax benefit rule since the subsidiary had realized no benefit from the liquidating distribution; and advises the Commissioner to appeal to Congress if he is dissatisfied. The dissenting opinion (324 F.2d at p. 840) winds up in confusion, recommends remand to the Tax Court for clarification.

In *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F.2d 378 (6th Cir. 1978), *cert. denied*, 440

U.S. 909, one corporation (parent) purchased the stock of another (subsidiary) and liquidated it. Among the trucking business assets distributed by the subsidiary were tires and tubes which it had taxably expensed. Sections 332, 334(b)(2) and 336 applied, the question being whether the subsidiary should nevertheless be taxed on the value of distributed tires and tubes.

The Tax Court majority opinion is short (65 TC 440, 1975); recognized that Section 336 prevented taxing that value to the subsidiary, but invokes the tax benefit rule to tax it anyhow. The affirming opinion of the Sixth Circuit majority: asserts "fictional" disappearance of tires and tubes when expensed, "fictional" recovery thereof just before liquidation distribution; reasons alternatively that the subsidiary recovered the value of its own stock through liquidation; and states that, in any case, inconsistency, without recovery, supports application of the tax benefit rule. 582 F.2d at p. 382. Neither of the majority opinions notes the point-of-purchase tax detriment to purchasing stockholder, or the gains tax to selling stockholders which is effectively duplicated by the corporate tax imposed.

The dissenting opinions reveal a better grasp of the problem. That of Tax Court Judge Tannenwald (65 TC at p. 449), concurred in by six other judges, relies on Section 336 and reasons primarily that: the tax benefit rule requires a recovery by the same taxpayer that profited from the prior deduction; a liquidating distribution of property involves no such recovery. He adds that such distribution does not provide the distributor with double deduction, the second deduction being by the distributee and deriving from the new basis specifically awarded by Section 334(b)(2). He might have added that selling stockholders suffered tax detriment on their gain. The dissenting opinion of Circuit Judge Weick (582 F.2d at p. 383) follows that of Judge Tannenwald and approves *South Lake Farms*.

The Ninth Circuit's *Bliss Dairy* decision that a corporation being liquidated under Section 333 may not be taxed on distribution of previously expensed feed, rests on the *South Lake Farms* decision and the words of Section 336.

IV.C. *Other Lower Court Decisions That Involve Section 336 or 337.* The majority of lower court decisions, other than those at issue before this Court, are concerned with sales made by corporations in the course of Section 337 liquidations.

Some courts distinguish between Section 336 and 337 where the impact of the tax benefit rule is allegedly involved, referring to the need for a recovery to invoke the rule, finding such where a Section 337 sale is made, finding none where a Section 336 distribution occurs.

This brief is in full agreement that no recovery of a prior deduction occurs, so as to invoke the tax benefit rule, when property is distributed in liquidation under Section 336. A corporation and its stock disappear when liquidation occurs; the corporation recovers nothing and realizes no benefit. The decisions applying the tax benefit rule to property sales under Section 337 are therefore not apposite to the *Bliss Case*, the *Pending Case* or Section 336.

We submit, however, that the tax benefit rule should not be applied to a Section 337 liquidation: because the sale that effects the recovery is tax-free under Section 337; because the alleged corporate tax deduction benefit is offset by the detriment of gains tax to distributee stockholders or selling stockholders; and because the statutory tax pattern for corporate liquidations generally intends that only stockholders, not the corporation, should be taxed whether Section 336 or 337 applies.

IV.C.1. *Decisions Refusing to Tax a Liquidating Corporation That Distributes Assets.* In *The Diamond A Cattle Company v. Commissioner*, 233 F.2d 739 (1956) the Tenth Circuit Court of Appeals held that a corporation was entitled to carry back a net operating loss under Section

122(b)(1) of the Internal Revenue Code of 1939 even though, under the corporation's accounting method, the loss resulted because cattle, which would normally have been sold, were instead distributed in liquidation. The Court admonished the Commissioner that if correction was needed it should be sought from Congress.

In *Ballou Construction Company, Inc. v. United States*, 526 F.Supp. 403 (D.Ct.Kan., Aug. 1981), a corporation was liquidated after sale of its stock, Sections 332, 334(b)(2) and 336 being applicable. The corporation had deducted expenses related to a sand deposit which was distributed in liquidation. The Court upheld application of Section 336, rejecting the tax benefit rule because the distribution involved no recovery.[15]

IV.C.2. *Decisions Taxing a Liquidating Corporation.* The Government's brief cites decisions taxing a liquidating corporation upon its sales, in spite of Section 337. These may be grouped as involving: supplies and materials previously expensed,[16] prepaid advertising,[17] construction contract profit to the extent not previously taken into income.[18]

That brief also cites decisions which, in spite of Section 336, tax liquidating corporations upon their distribution of

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[15]*Bonaire Development Company v. Commissioner*, 76 TC 789 (May 1981) holds that prepayment of a monthly management fee is not properly deductible and opines that if it were, the tax benefit rule would apply despite Section 336. Apparently, the decision is on appeal to the Ninth Circuit which might not approve the Tax Court's Section 336 comments.

[16]*Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970); *Commissioner v. Anders*, 414 F.2d 1283 (10th Cir. 1969), *cert. den.* 396 U.S. 958; *Anders v. United States*, 462 F.2d 1147 (Ct. Cl. 1972), *cert. den.* 409 U.S. 1064; *Estate of Munter v. Commissioner*, 63 T.C. 663 (1975).

[17]*Connery v. United States*, 460 F.2d 1130 (3d Cir. 1972).

[18]*Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962), *cert. den.* 373 U.S. 909; *Midland-Ross Corp. v. United States*, 485 F.2d 110 (6th Cir. 1973).

accounts receivable and customer contracts not previously taken into income.[19]

The opinions in those cases rely upon a variety of unconvincing theories. The most prominent of these is the tax benefit rule. That rule is sensible when a single taxpayer is affected by some event that cannot properly be accounted for taxwise under its regular accounting method. A typical example is the recovery of a debt that has been written off in a prior accounting period (Section 111 had to be enacted to restrain the Commissioner from taxing the recovery when there was no tax benefit from the prior deduction).[20]

However, the tax benefit rule gets into difficulties in corporate liquidation situations because, as previously noted, it takes no account of the taxable gain to shareholders who have sold their stock or liquidated their corporation; because its application violates the statutory words; and because, in Section 336 situations, there is no recovery by the corporation of the kind described in Treasury Regulations 1.111-1(a)(2).

Another untenable theory is that Section 446(b) authorizes the Commissioner to change the accounting method of a corporation because it liquidates. The liquidation demonstrates no defect in the corporation's regular method of accounting adopted pursuant to Sections 446(a) and (c);

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[19]*Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961); *Family Record Plan, Inc. v. Commissioner*, 309 F.2d 208 (9th Cir. 1962), *cert. den.* 373 U.S. 910.

[20]*Unvert v. Commissioner*, 656 F.2d 483 (9th Cir. 1981) is typical of the cases where the same taxpayer realized tax benefit from a deduction in one year followed by a recovery in a later year. *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969), cited six times in the Government's brief, is similar; it involved interpretation of Section 1341 concerning restoration of an item of income, by the same taxpayer which had previously been taxed thereon under the claim of right doctrine, in such manner as to avoid double deduction for depletion. These decisions, and many others cited in the Government's brief which do not involve Section 336 or 337, are not in point here.

rather it is a special occurrence which brings that accounting to an end with tax consequences specified in the statutes.

In cases where the liquidating corporation distributes (Section 336) or sells (Section 337) previously untaxed income rights, there is occasional reference to the assignment of income doctrine, which originated with decisions that the earner of income, not the donee of the income right, is to be taxed when the income is collected.[21] The doctrine is inapplicable when the earner sells the income rights; and does not logically apply to a liquidating corporate earner because there is a new tax accounting for the rights in the distributee's hands and because other taxpayers (stockholders) are taxed with respect to the value of the rights. Furthermore, income rights are property which are not to be taxed when distributed or sold by a liquidating corporation under Section 336 or 337.

Some strange theories are found in the opinions, such as the theory that when supplies are taxably expensed they "fictionally" disappear, and then "fictionally" reappear immediately prior to distribution or sale in corporate liquidation. This is nonsense. Nor is it easy to accept judicial rationalization such as: that a disappearing corporation is "recovering" something when its stock evaporates; or that a "recovery" occurs because of alleged "inconsistency" between the statutory protection from tax afforded the corporation at its liquidation, and its earlier, proper, tax accounting entries.

The variety of tenuous reasons advanced in lower court opinions that favor the Commissioner demonstrate one

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[21] *Helvering v. Horst*, 311 U.S. 112 (1940).

thing: that he has circumvented the words of Sections 336 and 337 any way he could.[22]

The Government's brief cites two decisions and Revenue Rulings that restore bad debt reserves to the income of a liquidating corporation.[23] These do not fly in the teeth of Section 336 or 337 because they deal with an accounting reserve that is somewhat separated from the individual receivables that are distributed or sold as corporate property. Further comment is appropriate, however. One of the decisions, *Home Savings & Loan Association*, did not mention Section 336 or realize that it was involved (contrary to the statement in footnote 32, page 43 of the Government's brief). The other, *West Seattle National Bank*, preceded this Court's decision in *Nash v. United States*, discussed in IV.A. above. The rulings purport to conform to *Nash* by taxing only such part of the liquidating corporation's reserve

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[22]The confusion of the lower court opinions is reflected in the writings about them over the many years since this Court has considered a proposal by the Commissioner to tax distribution or sale by a liquidating corporation. See *e.g.* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 4th ed., ¶¶ 11.61, 11.62, 11.65.3; Gutkin and Beck, *Section 337: IRS Wrong In Taxing, At Time Of Liquidation, Items Previously Deducted*, The Journal of Taxation, Sept. 1962, p. 146; Broenen, *The Tax Benefit Rule and Sections 332, 334(b)(2) and 336*, TAXES, April 1975, p. 231; Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, The Notre Dame Lawyer, Dec. 1980, p. 215. The following quotations from Bittker and Eustice are of interest: "Similarly, since the liquidation itself is often the Service's last clear chance to tax the disappearing corporation on its appreciated assets or other sources of future income, the government frequently seeks to sidestep §336 by asserting a deficiency based on some theory other than the mere distribution of assets in liquidation." (pp. 11-57); "Similarly, the decision in Fribourg Nav. Co. v. CIR, allowing depreciation to be deducted in the year property was sold for more than its adjusted basis, indicates that the Supreme Court is not very sympathetic to judicial or administrative disallowance of an item that seemed deductible on the facts as known when the expense was incurred." (pp. 11-63).

[23]*Home Savings & Loan Association v. United States*, 514 F.2d 1199 (9th Cir. 1975), *cert. den.* 423 U.S. 1015; *West Seattle National Bank v. Commissioner*, 288 F.2d 47 (9th Cir. 1961); Rev. Rul. 78-278, 1978-2 Cum. Bull. 134; Rev. Rul. 78-279, 1978-2 Cum. Bull. 136.

es is not matched by the transferee's gap between basis and face value of the receivables; reversing the Commissioner's earlier position that the entire reserve was taxable. By focusing on the transferee's basis for receivables, even the new rulings overlook its basis for all distributed assets and the taxable gain of shareholders or former shareholders of the liquidating corporation which created that basis.

This brief suggests that *Nash* requires observing the statutory words not only of Section 351, but also of Sections 336 and 337; with the logical conclusion that no tax shall befall the distributions or sales of the liquidating corporation, whether related to bad debt reserve or to any other source not specified by the statutory exceptions.

IV.D. *Summary: The Statutory Mandate Has Been Properly Observed by This Court and Some Lower Courts; Contrary Lower Court Decisions Have Ignored the Statutory Words and Pattern.* In its decisions and comments discussed in IV.A. above, this Court has obeyed the statutory words, whether or not the result seemed to favor the taxpayer, and has appreciated that the statutory language was fashioned in the legislative process, should be altered only by that process. This Court's decision in *Fribourg Navigation Company v. Commissioner* followed that principle in a Section 337 situation.

None of the lower courts that tax the liquidating corporation has considered Sections 336 and 337 in the context of the overall statutory pattern described in II. and summarized in II.E., above. Few have considered the statutory trade-off by which stockholders are taxed on gain that counterbalances or exceeds any untaxed corporate gain. None has fully appreciated the general rule intentionally provided by Congress for corporate liquidations: single tax on shareholders, rather than double tax on corporation and shareholders. None has noticed that Congress, having specified double tax exceptions to the general rule, thereby impliedly rejected interpretative exceptions that might be offered by

the Commissioner or courts. None has adverted to Section 341 and its: recognition that corporate income may escape taxation at liquidation; prescription that, if the liquidation process has been abused taxwise, the tax correction applies to the stockholders, not the corporation.

Lower courts have listened when the Commissioner cried "double deduction", not really understanding that the second deduction is provided by establishing a new basis with gain upon which shareholders or former shareholders have been taxed; which is what commonly occurs when any buyer buys assets from any seller that makes a gainful sale.

In the case at bar the Commissioner marshals his array of theories to override Section 336. He would impose on Bliss Dairy corporation, when liquidated under Section 333, a tax that its stockholders must thereupon pay, contrary to statutes which prescribe that they shall be taxed only on their disposition of distributed assets and only on gain measured by reference to their stock cost. If successful here, he would tax the liquidating corporation in the *Pending Case*, thereby effectively taxing the purchaser of its assets, double taxing the same values to corporation and selling stockholders, contrary to statutes which provide for single taxation of the selling stockholders only.

It is time for this Court to dispel confusion, redefine the proper judicial function as that of interpretating, not rewriting, tax statutes. If the statutory words are plain, as are the words of Section 336, and if the statutory pattern supports them, as does the pattern surrounding Section 336, the words should be enforced by the courts as written by Congress.

CONCLUSION.

The judgment of the Ninth Circuit Court of Appeals in the *Bliss Case*, Number 81-930, should be affirmed. We further urge this Court to express its opinion that Section 336 and the surrounding statutory pattern should be observed

as written, not contradicted by administrative or judicial interpretation; in order that future litigation may be avoided in cases like the *Pending Case*.

Dated: July 9, 1982.

Respectfully submitted,

ARTHUR A. ARMSTRONG,
as *Amicus Curiae*,
DAVID J. CARTANO,
VOEGELIN & BARTON.

Docket Sheet

NO. 81-930-CFX	TITLE United States, Petitioner v. Bliss Dairy, Inc.

DOCKETED	COURT
Nov. 16, 1981	United States Court of Appeals for the Ninth Circuit

DATE	PROCEEDINGS AND ORDERS
	Counsel for Petitioner: Solicitor General
	Counsel for Respondent: James Silhasek
Oct. 19, 1981	Application for an extension of time to file petition for writ of certiorari and order granting same until November 21, 1981 by Rehnquist, J, Oct. 21, 1981.
Nov. 16, 1981	Petition for writ of certiorari filed. (Record filed).
Dec. 22, 1981	DISTRIBUTED. 1-15.
Jan. 8, 1982	Brief for the respondent in opposition filed. (D).
Jan. 18, 1982	Petition GRANTED. The case is consolidated with 81-485 and a total of one hour is allotted for oral argument.

Feb. 5, 1982	Motion of the parties to dispense with printing the joint appendix filed.
Feb. 10, 1982	DISTRIBUTED. 2-26. (Above motion)
Feb. 11, 1982	March 4, 1982 - Petitioner Hillsboro National Bank shall file its opening brief.
	April 3, 1982 - The Government will file a single brief, responding to petitioner Hillsboro National Bank's brief and as petitioner in No. 81-930.
	May 3, 1982 - Respondent Bliss Dairy, Inc. will file its answering brief.
Mar. 1, 1982	The motion of the Solicitor General to dispense with printing the joint appendix is GRANTED.
Apr. 2, 1982	Order extending time to file the Government's brief on the merits until May 3, 1982.
Apr. 30, 1982	Order further extending time to file the Government's brief on the merits until May 17, 1982.
May 18, 1982	Brief for petitioner filed. (Respondent in 81-485).
May 24, 1982	Motion of Bliss Dairy, Inc. for divided argument filed.
June 7, 1982	The motion of Bliss Dairy, Inc. for divided argument is GRANTED.
June 14, 1982	Order extending time for respondent to file the brief on the merits until July 16, 1982.
	(Over)

81-930

Title

No.

DATE	PROCEEDINGS AND ORDERS
July 14, 1982	Brief, amicus curiae, of Arthur A. Armstrong filed.
July 15, 1982	Order extending time to file respondent's brief on the merits until July 19, 1982. (Orally, June Hoffman).
July 19, 1982	Brief, amicus curiae, Ameron, Inc. in support of respondent file.
July 21, 1982	Brief for the respondent filed.
Sept. 3, 1982	CIRCULATED.
Oct. 26, 1982	Reply brief for petitioner U. S. filed. (D).
Nov. 1, 1982	ARGUED.